Unequal Voting and the Business Judgment Rule

Posted by Charles M. Elson (University of Delaware) and Craig K. Ferrere (U.S. Court of Appeals, Third Circuit), on Saturday, April 7, 2018

Editor's note: Charles M. Elson is the Director of the John L. Weinberg Center for Corporate Governance, and the Edgar S. Woolard, Jr., Professor, at the University of Delaware; Craig K. Ferrere is a term clerk for the Honorable Thomas L. Ambro of the United States Court of Appeals for the Third Circuit. 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.

Increasingly, company founders have been opting to shore up control by creating voting structures that undercut shareholder voting power, where only a decade ago almost all chose the standard and accepted one-share, one-vote structure. Now the Snap Inc. initial public offering has gone even further with the first-ever non-voting stock model. By offering stock in the company with no shareholder vote at all, Snap—the company behind the popular mobile-messaging app Snapchat (that is all about giving a voice to the many)—has acknowledged that public voting power at controlled companies is only a fiction. This stock ownership structure undercuts shareholder influence, undermines corporate governance, and will shift the burden of investment grievances to the courts.

Snap’s March 2017 initial, non-voting-stock public offering is, in modern times, unprecedented. Its multi-class, non-voting capitalization gives Evan Spiegel and Robert Murphy, the company’s founders, and holders of ten-vote shares, a lifetime lock on control, without the need to retain an expensive ownership position. They exercise a decisive 89 percent of the voting power, despite holding only about 44 percent of the company’s total equity.

1 Nonvoting shares are not historically unprecedented. However, except for a brief period in the early twentieth century, they have been used to avoid rather than facilitate concentrations of control. See David L. Ratner, The Government of Business Corporations: Critical Reflections on the Rule of 'One Share, One Vote,' 56 Cornell L. Rev. 1 (1970); Joel Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 Geo. Wash. L. Rev. 687 (1986).

2 Lucian Bebchuk and Kobi Kastiel argue that, assuming dual-class ownership is permitted, the arrangement should at least include a “sunset” provision limiting the time before ordinary shareholders are allowed to vote on whether the company should continue on in dual-class form. Lucian Bebchuk & Kobi Kastiel, The Untenable Case for Dual-Class Stock, 103 Va. L. Rev. 585 (2017). Snap has a sunset provision (of sorts), which is triggered when both founders die. Evidence suggests controllers’ abilities decline over time and generations while the controllers nonetheless have incentives to retain the more and more inefficient structure. Id. (citing anecdotal evidence and numerous empirical studies). Indeed, a recent SEC study found that dual-class companies with sunset provisions outperformed those without. Commissioner Robert J. Jackson, Jr., Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2016), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty#_ftn21.
A New Deal For Shareholders

Dual- and multi-class capitalizations—in which founders and other insiders retain a class of high-vote shares while selling low-vote shares to the public—are nothing new for controlled companies. This mechanism has long allowed founding individuals and families to leverage minority economic ownership positions—say 10 or 20 percent—into total voting control of large companies such as Snap, Facebook, and Google. But the Snap plan stretches this logic to its limit—with no-vote shares, founders can sell off all but one voting share, and, nonetheless, control every aspect of company policy.

With zero-vote IPO stock, the logic of leveraging control from a minority interest through the dual-class structure has now reached its illogical conclusion. With non-voting shares, a founder can advise investors plainly, without any pretense or suggestion otherwise, that she will take their money but not their advice. We’ve reached the zenith, and in its wake is the normalization of the disenfranchisement of public shareholders through dual- and other multi-class structures.

The one-share controller hypothetical is, indeed, extreme. It is not, however, farfetched. There is a strong tendency for controllers to reduce their equity interest over time. The high cost to founders of monitoring management and holding large, illiquid, and undiversified positions in a single company explains this push away from concentrated ownership.

Though a controller is unlikely to reduce her position to a penny, the controller-divestment phenomenon leads to extreme agency costs even at far less extreme points of divestment. As Lucian Bebchuk and Kobi Kastiel have explained, significant agency costs arise well before total controller divestment. As the fraction of the company’s cash flow rights held by the controller decreases, he or she can foist more of the cost of personal benefits taken from the company onto the other shareholders. This creates an incentive for the controller to make more inefficient choices over a range of outcomes that are increasingly bad for the minority shareholders. The result of this two-pronged dynamic is that expected agency costs increase sharply as a controller’s proportional cash flow rights decrease. As a result, a reduction of ownership from just 20% to 15% more than doubles the expected agency costs.

How We Got Here

Not long ago, even simple dual-class capital structures were the anachronistic refuge of either media conglomerates or old-style industrial titans. Companies used the structure when the requirements for journalistic integrity and independence from the market demanded a safe-harbor fortified by an impregnable curtain of voting control—the New York Times Company, News Corp., and the Washington Post are the representative adopters. It was also used at companies built by a founder through such singular achievement that the market could be strong-armed into accepting little-to-no protection in exchange for the capital it was giving, in trust, to a “genius.” The Ford Motor Company, Berkshire Hathaway, and Estée Lauder Companies are some well-known examples.

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3 Bebchuk & Kastiel, supra note 2, at 609 (finding that for the ten largest dual-class companies listed in the United States in 2015 the controller’s equity ownership had fallen since the time of the IPO, on average, from 30 to 12 percent). 4 Id.
A twenty-first-century trend, begun by Google in its 2004 IPO, is driving the dual-class capital structure out of the uncommon and into the mainstream. Increasingly, founders are opting to bolster control through highly leveraged voting structures, compared to the standard and accepted one-share, one-vote structure that was a constant for fear of an investor revolt and a public relations maelstrom.

Today 9% of the S&P 100—representing $2.26 trillion in market capitalization—is dual-class. In the Russell 3000, such companies represent 8% of the index. Now, the phenomenon extends well beyond the technology and media industries. Significant dual-class companies include AMC, Box, Nike, Ralph Lauren, Tyson Foods and Under Armor. (The Council of Institutional Investors maintains a complete list.[1]) As dual-class controlled companies are steadily increasing in prominence hard thinking about the importance of the shareholder vote is due. More than one-in-nine of the new companies added to the Russell 3000 index through IPOs is dual-class. In 2015, 13.5% of the 133 IPOs listed dual-class shares, compared to just 1% in 2005.

Many companies took Google’s example and pushed the envelope even further. Among them, Zynga, which went public in 2011, raising over $1 billion, had a founder-only class of stock with a staggering seventy votes per share. Zynga’s founder, Mark Pincus, has effective control with 37 percent of the vote, despite having only a 12 percent economic interest in the company. Prior to 2016, Groupon, Inc., had a 150:1 voting ratio and Universal Health Services has a 1,000:1 ratio.

That said, Snap’s issuance of shares with no vote was unprecedented: instead of having no effective voting power, its new shares have no actual voting power. The structure will allow its co-founders, twenty-six and twenty-eight years old, to control the company until the day both are dead. The growing number of dual-class companies in the American economy together with the advent of no-vote stock raises serious questions about how the courts will view transactions involving these companies, in light of the accountability that a meaningful shareholder vote provides.

No-Vote Shares in the Courts

Contemporary criticism of dual-class capitalizations has focused on the reduction in accountability. However, the lessened accountability’s effect on the approach that courts must take in reviewing the actions of these companies and their boards has not yet been considered. This issue presents the most significant problem with permitting the use of dual-class structures. We must reconsider the long-settled policy of judicial restraint wherein courts have concluded that with regards to business judgment management action will not be reviewed at all. American courts may decide that more active judicial intervention is necessary—because without a vote shareholders can’t provide oversight of boards and thus management—and take on greater responsibility for shareholder protection at these companies.

In most circumstances, when an disinterested and independent board of directors has acted in “good faith” and “with reasonable care” its decision will be considered a business judgment and not be interfered with by a reviewing court. This rule expresses the judicial reticence to second-guess the complex, real-time decisions of management. Where applied, the view that judicial regulation of management’s business judgment will not serve as a measure of additional shareholder protection justifies the rule.
Ordinarily, markets and corporate democracy get the job done, so courts need not. Thus, judges typically will not step up to protect shareholders from bad managerial decisions. Doing so would be duplicative and unproductive. All things equal, bad management leads to poor company performance, which leads to depressed stock prices. Falling equity values hit executives hard, as today most of their pay and much of their assets are made up of stock and options. Glum results also beacon corporate raiders who, once inside, will fire the existing management and install more effective managers. Unemployed, formerly bad managers will find their prospects limited as companies want to hire high performers and today managers are evaluated by how high stock prices rise. This dynamic alone should spur effective action from any manager at all interested in her reputation, career longevity, and finances.

There is little use in the courts piling on after all is said and done. Shareholders, by voting, can decide what to do with the ineffective managers. For mistaken business judgment, a court’s post-hoc imposition of liability is only likely to chill corporate risk-taking. There is no reason to believe, in any case, that judges will more ably decide the matter than managers and directors, who possess superior substantive business acumen. Add the considerable expense and delay from litigation and it is no wonder courts leave shareholder protection largely to the markets and the vote.

Markets can constrain the discretion of the controllers of one-share-class companies too. Even without the ability for minority shareholders to monitor them, large equity positions create powerful incentives for a controlling owner to run a tight ship. After all, she will bear a large part of the cost of every company expense and failed venture. In many respects, concentrated ownership is an antidote to the problem of monitoring management when shareholders are multiple, small, and dispersed. But the market does not punish controller self-dealing, as the direct fruits outweigh the proportional share of lost firm value borne by the controller. So, this is the point at which courts take a stand.

The flip side of the idea that courts should not provide extra corporate control where markets do it better is that when markets fail the courts should be ready to jump in. Thus, they deploy greater

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6 Courts have repeatedly stated that "mere allegations of that directors made a poor decision . . . do not state a cause of action." Ash v. McCall, 2000 WL 1370341, at *10 (Del. Ch. Sept. 15, 2000). This covers "degrees of wrong extending through 'stupid' to 'egregious' or 'irrational.'" In re Caremark Int'l, 698 A.2d 959, 967 (Del. Ch. 1996).
7 Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000) ("The inquiry here is not whether we would disdain the composition, behavior and decisions of a board 'if we were stockholders, . . . That decision is for the stockholders to make in voting for directors, urging other stockholders to reform or oust the board, or in making individual buy-sell decisions.").
8 Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P., 906 A.2d 168, 193 (Del. Ch. 2006), aff'd, 931 A.2d 438 (Del. 2007) ("[B]usiness failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that seem to promise great profit."); Gagliardi v. Trifoods Int'l, 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[O]nly a very small probability of director liability based on 'negligence', 'inattention', 'waste', etc., could induce a board to avoid authorizing risky investment projects to any extent.").
10 See Convin v. KKR Fin. Holdings LLC, 125 A.3d 304, 313 (Del. 2015) ("When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them.").
11 Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (holding that a decision by a controlling parent corporation is protected by the business judgment rule unless "the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."); see also In re Martha Stewart Living Omnimedia, Inc. Stockholder Litig., 2017 WL 3568089, at *11 (Del. Ch. Aug. 18, 2017).
scrutiny of interested transactions, culminating in the severe entire fairness standard. But these more exacting standards of review are reserved for transactions that expose conflicted controller interests that exclude the minority interests. Thus, as in *Sinclair Oil Corp. v. Levien*, a subsidiary’s proportional dividends are not subject to fairness review, for example, while its contracts with the parent corporation might be. 280 A.2d at 721–22, 723.

And even in these problematic circumstances, the courts are willing to walk back scrutiny so long as steps are taken to mimic market controls. By doing so, the transactions more resemble those within courts’ markets-backed comfort zone. For instance, in controller transactions the informed approval of a majority of the minority shareholders shifts the burden of proof on the issue of fairness to the plaintiff. The same effect follows the use of an independent committee of directors. The combination of these two methods can win the transaction business judgment review. 12 Altogether, there is an effort by the courts to substitute a form of market review for judicial review.

**An Evolution in the Law? We Think Not**

The *Sinclair Oil* rule makes less sense when applied to dual-class controlled companies. Unlike a single-class controlled company, for a dual-class controlled company there may be neither market nor board constraints. 13 A dual-class controller may bear very little of the cost of inefficient management and bad strategy. Through leveraged, multi-class ownership structures, she may, in the end, own only a small percentage of the company. Market incentives are significantly eroded, as only a fraction of the consequence of poor management is borne by the controller. In the case of the one-share controller hypothetical, those incentives would be non-existent. Thus, significant deviations from the efficient operation of the business can be sustained at the expense of the public shareholders who hold the majority of the firm’s economic interest. (In a recent paper, Lucian Bebchuk and Kobi Kastiel discuss in depth the incidence of and problems with these “small-minority” controllers.)

The $2.6 billion pay package awarded by Tesla to Elon Musk, its founder and controller, suggests a dollar figure for the scale of the eroded incentives. He will earn $50 billion if he meets a set of ambitious performance objectives. Tesla did not fear that Musk, a driven entrepreneur, would slack generally. Rather, the company sought to buy his attention with “a sum so large it might just ensure that Musk’s array of other passions and esoteric side projects won’t steal too much time from his work at Tesla.” Consider also Facebook’s recently proposed but then scrapped plan to issue nonvoting stock so that Mark Zuckerberg, its founder could offload $74 billion to charity, reducing his economic interest to 3 percent, without losing control.

Courts will need to confront this challenge to traditional business law doctrine. Without board and market forces protecting shareholder interests, the burden of monitoring investments and dealing with problems will end up in the courts. The judiciary must determine whether to add heightened review of operational decisions at dual-class controlled companies to the already heightened

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13 See generally Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Value*, 125 Yale L. J. 560, 591–92 (2016) (“while the exposure to the control-agency problem is high in a dual-class structure (high incentive due to small equity), it is only moderate in the concentrated ownership structure (low incentive due to large equity). . . . Under a “one share, one vote” regime, the entrepreneur can retain control only if she holds cash-flow rights sufficient to give her control.”).
review of interested transactions. The alternative is allowing a new breed of unaccountable and unmotivated controlled corporations.

Of course, if courts decide to scrutinize a dual-class company’s transactions more forcefully, the minority shareholders of such companies are free-riding by shifting the costs of monitoring bad management to the judicial system. The public expense and difficulty of the resulting judicial review is another reason for restricting or eliminating dual-class ownership.

But there are costs imposed on America’s corporate courts even if they choose not to provide a meaningful heightened review. Those courts treat the protection of shareholder interests as their primary task and objective. If the courts choose not to engage in heightened scrutiny, allowing dual-class company founders a relatively free hand, the judiciary’s credibility and reputation will be harmed. That position also contradicts the doctrinal framework governing judicial review of corporate conduct. No doubt this is a problematic posture for the judiciary: the recognition, on the one hand, of a critical need for oversight, coupled with the decision to stay out of it. Judges are unaccustomed to throwing up their hands in the face of present harm.

What will the courts choose to do? Our belief is that they will continue to abstain from engaging in heightened review of day-to-day, non-conflicted transactions at dual-class controlled companies. Courts are ill-suited for policing poor managerial performance and low effort. Looking at a single unfavorable outcome, it is near impossible for a court to observe whether the cause was bad luck or bad management.14 Across that expanse of time and knowledge, judges are unable to substitute their business judgment for that of experienced corporate management. Thus, while heightened review might be doctrinally prudent, it is practically unfeasible. The result will be a growing number of dual-class companies that are unaccountable to shareholders, the markets, and the courts. In consequence, we may need to discard the entire dual-class structure.

If not, we may end up with a governance snap-judgment day.

14 Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (“The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.”); see also Paramount Commc’ns Inc. v. Time Inc., 1989 WL 79880, at *30 (Del. Ch. July 14, 1989) (“The value of a shareholder’s investment, over time, rises or falls chiefly because of the skill, judgment and perhaps luck—for it is present in all human affairs—of the management and directors of the enterprise.”).
The case for the ‘legal director’

Why you need one on your board
When Google was going public in 2004 with a dual-class share structure, in which the Class A common stock being offered would have one vote per share while a Class B common stock held by management and existing shareholders had 10 votes per share, the company advised potential new investors thusly:

“Google has prospered as a private company. We believe a dual class voting structure will enable Google, as a public company, to retain many of the positive aspects of being private. We understand some investors do not favor dual class structures. Some may believe that our dual class structure will give us the ability to take actions that benefit us, but not Google’s shareholders as a whole. We have considered this point of view carefully, and we and the board have not made our decision lightly. We are convinced that everyone associated with Google — including new investors — will benefit from this structure. However, you should be aware that Google and its shareholders may not realize these intended benefits.”

This was a remarkably forthright ‘heads up’ to potential shareholders. Google has subsequently followed up its successful IPO appearance as a dual-class company with a proposal earlier in 2012 to issue a new class of non-voting stock that would further consolidate management’s control — or, “complete chokehold,” as critics like Reuters Breakingviews news service called it — of the company. And coming to market within the past year with a dual- or multiple-class structure have been such hotly anticipated (at the time of their IPO) tech companies as Facebook, Zynga, Groupon, and LinkedIn. The spotlight on dual-class stock is not reserved just for technology IPOs. The high-profile U.K. sports organization Manchester United went public on the New York Stock Exchange with dual-class shares in July 2012 as this article was being prepared for publication, and a dual-class ownership structure has been a sore point for shareholders of the Rupert Murdoch-dominated News Corp., especially since the hacking scandal broke last year.

Financial Times columnist Andrew Hill perhaps best formulated the conundrum facing any analysis of dual-class stock: “The advantage of a dual-class share structure is that it protects entrepreneurial management from the demands of ordinary shareholders. The disadvantage of a dual-class share structure is that it protects entrepreneurial management from the demands of shareholders.”

Is there any reconciling the conflicting sentiments and analyses? In April 2012 Charles Elson convened a panel at the University of Delaware’s Weinberg Center for Corporate Governance to examine the tradeoffs of dual-class stock. The panel was a smartly composed mix from the corporate and legal sector, the media, academia, and the institutional investor community. (This is the fifth in a series of roundtable collaborations that Directors & Boards has done in conjunction with the Weinberg Center of Governance over the past dozen years.) Highlights of the panelists’ spirited debate follow.

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Charles Elson: You’re exporting the monitoring function

Charles Elson is the Edgar S. Woolard Jr. Chair in Corporate Governance and director of the Weinberg Center for Corporate Governance at the University of Delaware. He has served on several corporate boards, including a present directorship on the HealthSouth Corp. board. He is a member of the Directors & Boards editorial advisory board.
Our legal system of governance has traditionally been predicated around the notion of voting control based on one share, one vote — the idea being that if you didn’t like what managers were doing you could vote them out. But a dual-class structure is an odd exception to this typical formula, and it raises all kinds of legal issues, particularly about the obligations of the controlling shareholder to the other shareholders.

One view of dual-class stock is that the only ones potentially being harmed are those that invest in a company with a dual-class structure. After all, they don’t have to make that investment. If you read the Google IPO document it has a very explicit warning about its having a dual-class structure and that investors may not be happy with the ramifications of that.

But are the harms limited only to the shareholders? Are the harms actually much broader, much more societal-based? Where you have dual-class stock, the controlling shareholder controls the board. Though having legal responsibilities to oversee management and monitor effectively, the board, practically speaking, becomes much less of a monitor. Instead, what you’re doing is exporting the monitoring function to third parties — to the government, the courts, the regulators. That then creates a significant public cost. In the end, when there is a problem and someone has to clean up the mess that maybe a beholden board has not caught, the damage isn’t just limited to the shareholders. The damage is to society in general and the public pays for it.

The debate over dual-class share ownership is moving beyond the notions of board accountability impacting cost to the individual investor to a wider economic rationale based on cost to the public.

The Council of Institutional Investors opposes dual-class stock structures because we are opposed to unequal voting rights. While dual-class structures may seem attractive when brilliant founders are running the entity, we believe the structure is fundamentally flawed as a long-term capital model.

The Council has long believed that when it comes to public equity markets voting power should be proportional to the economic interests of the holders. When the Council formulated its bill of rights after it was formed in 1985, the first provision was “one share, one vote.” The vote is very important. It’s a tool for holding management accountable and having a say on major issues.

You have to remember that not all investors are actively selecting their equities. Some equities are owned because they’re part of broader indexes, like the Russell 3000, which have a number of dual-class companies in them — Google, Comcast, Ford, News Corp., New York Times Co. Council members are heavy users of passive strategies and can’t simply exercise the Wall Street Walk and sell if they’re unhappy with management.

The argument that a dual-class stock is priced at a discount — so, “no harm, no foul” — is of no solace for us when the company may hit hard times, or when second generation of leadership isn’t doing the same excellent job that the first generation has been doing. Council members want boards that are empowered to actively oversee management and to make course corrections when appropriate. When directors essentially can be hired or fired by a single person or a family makes it difficult for directors to exercise fully their legal duties to act in the best interest of all shareholders.

Finally, to those proponents who argue that the structure promotes long-term thinking which is in the best interest of the company and its shareholders, let me make this observation. Clearly, Council members are long-term owners. They have long investment horizons, they’re passive, so they applaud boards and management for focusing on the long term. However, I think dual-class stock is created with short-term thinking in mind, because this is really about entrenching leaders — those taking a company public — at the expense of the company’s long term.

Ann Yerger: Fundamentally flawed as a long-term capital model

Ann Yerger is executive director of the Council of Institutional Investors. The Council is an organization of more than 140 public, corporate and Taft-Hartley pension funds that manages over $3 trillion in assets. She joined the Council in 1996 and was named to her present position in 2005.
Geoff Colvin: A legitimate issue of public policy

Geoff Colvin is senior editor-at-large for Fortune magazine. He has been a longtime editor and columnist for Fortune and is one of its keenest commentators on corporate leadership. During his time at the magazine he has also done extensive and award-winning work as a broadcaster, speaker, and book author.

The capital markets system we have in this country makes sense when voting power is proportional to economic interest. It was designed on the basis that the people with the greatest economic interest in the business determine the board of directors. That’s the mechanism we’ve built, one by which the board can then do its job, including the task that some would say is its most important, which is making sure that the company always has the right CEO, and, if not, can fire the CEO.

In a company with dual-class stock, the mechanism is disabled because the CEO, as a practical matter, can fire the board. We no longer have rule of law, we have rule of man. Now, rule of man can work out great, if the person in charge happens to be enlightened and intelligent — the Robertses at Comcast, Bill Ford at Ford. Rule of man can work out great in a nation, too. Nonetheless, we don’t tolerate this in our important institutions. We don’t allow the rule of man and then hope that we get one of those enlightened people running the show. But we do tolerate it in one group of our most important institutions — publicly traded companies.

Now, I am a big proponent of free markets, but it seems there is a very legitimate question as to whether this matter of dual-class stock should be an issue of public policy.

The founders of the United States didn’t survey types of government around the world and then run a regression analysis to figure out which was going to be the most effective. They set up a governance system according to the principals that they thought made the most sense, and as a result we have what some people call a system designed by geniuses so that it could be run by idiots.

It’s the same nature of argument that we have here. Just as you can never say that in a democratic country you’re not going to have any scoundrels or scandals or simply bad government, we can’t say that by eliminating dual-class companies we could make sure that all companies are great performers. The argument is that we can move the needle a little bit — that by putting in the right incentives to behave the way the mechanism was meant to behave, we will incentivize better behavior under a single-class system than under a dual-class system.

Scott Goebel: Shareholders shouldn’t just be along for the ride

Scott Goebel is senior vice president and general counsel of Fidelity Management & Research Co., one of the world’s largest providers of financial services. It has assets under administration of $3.7 trillion, including managed assets of more than $1.6 trillion. He is responsible for legal matters pertaining to Fidelity’s investment advisory businesses, including its mutual funds.

At Fidelity, we have several hundred funds and nearly as many different investment styles and approaches, but I can boil down our approach to a relatively simple idea, which is that we try to do things that will increase the return of our funds, consistent with the investment objective of each fund. Our portfolio managers by and large are empiricists, by which I mean that if you can demonstrate a correlation that a particular activity or approach leads to enhanced value, we are more like to engage in that activity.

This tendency presents a bit of a problem when it comes to corporate governance, because much of what seems intuitively correct about governance cannot be proven. But we have three principles that we use in thinking about corporate governance issues broadly: 1) can we align management and the board’s incentives with the shareholders, 2) can we create accountability both with respect to management to the board and board to shareholders, and 3) are there going to be appropriate disclosures to shareholders of the relevant governance issues.

If you think about the narrower question of dual-class stock, all other things being equal, this capital structure is less likely to have alignment and less likely to have the accountability that we look for in comparison to single-class stock structures.
That is because there is a disconnect between the economics and voting authority in the dual-class stock structure.

The traditional model is one in which management actually runs the company on a day-to-day basis with oversight by a board of directors, which in turn has to be accountable to shareholders. Well, that accountability to shareholders is at least mitigated if not completely eliminated in some dual-class structures by the ability for management, through the exercise of super-voting rights, to have a much greater sway over how directors operate. That essentially leaves other shareholders just along for the ride.

A caveat. Although Fidelity funds generally vote against the adoption of dual-class structures, Fidelity funds nevertheless regularly invest in dual-class companies. Why do we do that? For a number of reasons, not the least of which is that some of these holdings have very compelling businesses and very strong management and are performing well.

So I am not proposing that we do away with dual-class stock because it’s some sort of a ‘poisonous’ structure that invariably harms shareholders. But if you’re thinking about a long-term approach to how companies should operate, we think that the feedback loop between and among management, boards and shareholders — and in particular the ability for shareholders collectively to monitor and have influence over boards — is vital.

David L. Cohen: Capital structure is the wrong determinate of accountability

David L. Cohen is executive vice president of Comcast Corp., one of the world’s leading media, entertainment and communications companies. Before assuming this position in 2002 he was a partner in and chairman of law firm Ballard Spahr Andrews & Ingersoll LLP and, from 1992 to 1997, served as chief of staff to Philadelphia Mayor Edward G. Rendell.

I am a lawyer by training and an executive at a company that has had a multiple-class stock structure since the day it went public. And I am a person who through my career has looked at most issues through the lens of pragmatism and not idealism. I’m not an evangelist for or against multiple-class capital structures. But this is what I would say to investors and the public who are interested in the performance of American business, in creating value for shareholders, in innovation and growth, in creating jobs, and in integrity and honesty: I don’t believe the questions about the capital structure of companies are particularly relevant to those goals.

I know that there are numerous academic studies purporting to link capital structure to financial performance, but there are other academic studies that reach exactly the opposite conclusion. Similarly, there are plenty of horror stories about companies with dual-class voting stocks and inappropriate — greedy and even illegal — acts committed by the holders of super-voting stock.

But I would argue there are even more stories of similar or worse conduct by senior executives in single-class voting stock companies. And, fortunately, there are plenty of examples of great performance by dual-class stock companies and their senior executives. The notion that those working in a dual-class stock company are somehow less accountable to the board and to the shareholders is just not the way that management thinks. It’s certainly not the way we think at Comcast.

Put all of that together and there is strong evidence that the prime determinant, the principle generator, of good performance and of the types of things that we all should be interested in from corporate America is not the capital-stock structure of the company. So what’s my pragmatic conclusion? I think if you have terrific management, an engaged board of directors, and a strong governance culture, you’re likely to have a great company, regardless of its capital structure. And if you have bad management, either by ability or by ethics or by approach to the business, with a subservient or inattentive board, and a poor governance culture, your company is likely to have problems — again, regardless of the capital structure of the company.

Frederick H. Alexander: Dual-class as a reaction to governance extremes

Frederick H. (Rick) Alexander is chair of the executive committee of Delaware law firm Morris, Nichols, Arsht & Tunnell LLP, where his work often involves counseling boards of directors. He has chaired Corporate Law initiatives with both the Delaware State Bar and the ABA, and is the co-author of the reference work, The Delaware Corporation: Legal Aspects of Organization and Operation.

Dual-class stock structure is an important issue in corporate governance and I think it’s going to
become more high profile in the next couple of years. Rather than analyze it as a black or white, or good or bad, issue, I want to make three points about the broader context in which this issue can be debated.

First, when you think about a spectrum of corporate governance, a dual-structure is far on one side of that spectrum. So if that is one extreme, then there is an extreme on the other end. And what would that be? I would submit the other extreme is precisely where we seem to be headed in U.S. corporate governance.

When I started practicing law 20-some years ago the classic model for a public company was to have a classified board and to provide for no action by written consent. That meant accountability to stockholders by taking control through the ballot, but only through a multi-year process. Now we’re moving in the direction of getting rid of classified boards and of denial of action by written consent, and we’re allowing stockholders to call special meetings, all of which suggest that we’re approaching an extreme in much of our governance system: immediate access to full control through the ballot. Seeing companies go public with a dual-class structure may be a reaction to that.

A second contextual point is more industry specific: when I started practicing law it was not unusual in reviewing the charter and bylaws of public Silicon Valley companies to find that, unlike many public companies, they did not have any antitakeover protection. They didn’t believe in that. They thought they were takeover proof — “their assets go home every night,” so if anybody tried to take them over, everyone would leave. Well, it became apparent that was not the case and that these companies were as vulnerable as anyone. So I find it very interesting that the same sort of companies — the Facebooks and the Zyngas of the mid to late 1980s and early ’90s — who were on one extreme then are the ones leading the charge to this other extreme today of adopting dual-class structures.

The final contextual point of importance is that dual-class stock is largely a public company phenomenon. You want entrepreneurs to have the ability to access the public markets on terms that they’re comfortable with. And you also want participants in the public markets to have access to investments across a very broad spectrum. With the defined-benefit pension going away, we’re moving as a society to a place where individuals are more responsible for their own savings and retirement. So whenever regulation — such as restricting the issuance of dual-class shares — may put somebody in a position where they’re then not going to access the public markets, you’re not only denying them access to those markets but you’re denying savers the ability to access certain investments.

J. Michael Cook: The best of the best?
A dual-class company

J. Michael Cook is a director of Comcast Corp. and International Flavors & Fragrances Inc., and has been a member of many other public, private and organizational boards. He began his career as an accountant in 1964 and from 1986 to 1999 served as chairman and CEO of Deloitte.

Because the conclusions on dual-class capital structures are not consistent, and are in fact contradictory, I did an analysis based on my own experience of serving on the boards of eight prominent, well-known, large and sophisticated U.S.-headquartered companies, only one of which happens to have a dual-class structure. It is not a statistical sample by any means but it’s a reasonably representative sample. And what I asked myself was: Which are the really good ones, and how good are they, both from a management standpoint and a governance standpoint?

In this group they’re all good companies, but in my mind the distribution of performance is fairly wide across them. A number would get As and Bs and a few would get a C or maybe a D. Most of these companies had good governance, with some having superb governance.

What did I learn from my own back-of-the-envelope approach? By far, the best-rated company on my list was the only company that has a dual-class structure — Comcast. So then I asked myself, what is it about this company that sets it apart from the others? And to what extent are those factors governed or affected by the fact that it has a dual class of stock?

The most important thing that people should be looking at when evaluating is whether a company has a superior CEO and a superior senior management team. In my experience, this is perhaps the single most significant factor in whether a company is going to be successful or not. At Comcast, I believe we do. I believe the leadership is very well aligned with the shareholders and is absolutely
committed to shareholder value. We do quarterly reporting like everybody else and we issue a lot of performance information on a quarterly basis. But the board view, and the management view, is very much on the long term.

Is that ability to attract and retain superior people at the top of this organization, and to have a long-term strategic view, influenced by having a dual-class structure? I can’t say for sure. It may not necessarily be any different from one type of ownership to another.

But maybe it is. We have a sensitivity to board and governance issues that is a bit heightened because of the fact that we do have different classes of shareholders. We think long and hard about the fairness — to everybody — of particular transactions and any degree of bias there might be to one shareholder group or another. Comcast’s counsel works with us on a very independent basis to help us think through those kinds of questions. So maybe that kind of sensitivity is a good thing. Maybe shareholders would be better served by boards who were a bit more sensitive to fairness kinds of issues.

In fact, a fruitful field of research might be to create an index made up only of companies with dual-class structures and compare performance over time with a standard benchmark like the S&P 500. We might find that to be an attractive group of companies to own.

While in my limited sample the best performance is coming from a company with a dual-class structure, my overall experience is that good people run good companies and will perform well for the shareholders, and bad people will do bad things which will be negative for the shareholders — and this has never had anything to do with the voting rights of classes of shares.

**Michael S. Geltzeiler: You are making a bet on management**

Michael S. Geltzeiler is group executive vice president and chief financial officer of NYSE Euronext, which operates the world’s largest equity exchange group. He is responsible for all aspects of finance, treasury and investor relations. Prior to assuming that role in 2008 he was CFO of the Reader’s Digest Association.

**At the NYSE** our governance rule allows for dual classes of stock. It can be structured that way at the IPO stage. However, once a company is public it can’t move to a dual class. NYSE has a long history of supporting investors. We view doing what is right for investors as one of our responsibilities, and we even have an individual investors’ advisory committee as part of our governance structure to help make sure investors have a voice in what happens at the NYSE. We are very supportive of job creation and stimulating the economy, so if allowing dual classes of stock permits a company to have access to the public markets which will enable them to grow, stimulate the economy, create more jobs, and provide investors a chance to participate in that growth in a transparent environment, then that certainly is a positive — as opposed to not going public, not growing, and not stimulating the economy if there was no ability to have a dual class of stock.

The tradeoff to investors is you are betting on management and their approach to value creation. The downside comes when the interest of controlling management is not aligned with the shareholders. I have some relevant experience with that from my time at Reader’s Digest (RDA).

The company went public in 1990 with dual-class shares. It was owned by two not-for-profit philanthropic foundations created by the founders, the Wallaces. I came in 2001 to be the CFO of the company and had to deal with some complexities of that dual-class structure. We had a situation where these not-for-profits needed cash to do what they do, and pushed us toward a dividend policy that wasn’t necessarily right for the company. In fact, for a period of time in the late 1990s, RDA was issuing dividends in excess of cash flows. There was a lack of alignment between the controlling shareholder and many of the other shareholders. Then along came some activist shareholders who felt a not-for-profit should not own a public company. We ended up unwinding the dual-class structure, with the support of the controlling shareholder, back to a single-share structure. That was not easy. In fact, because of the fairness issues, it got to the Delaware Supreme Court.

My conclusion is that public companies are built for the long term. The big challenge comes when a company is faced with strategic alternatives. In my career I worked at Dun & Bradstreet,
where we separated into three public companies. I worked at AC Nielsen, which we sold, and at Reader’s Digest, which went private. My current company, NYSE Euronext, was planning a merger with Deutsche Börse. In every one of these cases, when you’re faced with strategic alternatives, it’s a tough decision for the management and the board. You always want to look at what’s the right answer for the company, what’s the right answer for the shareholders, what creates the greatest amount of long-term value. That can become more difficult in a dual-class structure if one party views the firm not as the public’s company but as their business, one that they own.

**Michael Useem: A buffer to be a better strategic partner**

Michael Useem is the William and Jacalyn Professor of Management at the Wharton School of the University of Pennsylvania. He is also director of Wharton’s Center for Leadership and Change Management and is editor of the Wharton Leadership Digest. His research interests include enterprise risk management, corporate change, leadership, and governance.

The debate over dual-stock capital structures is a kind of window into other important aspects of corporate governance. Here is the argument that I would make that dual-class arrangements are probably a good thing, and can even have an enormous upside.

Boards have, of course, long served as monitors on behalf of stockholders, but also as strategic partners with management. What’s happened is that both of these functions have strengthened in recent years, strategic partnering in particular. What has strengthened that partnering function? Given the complexities that companies face and the uncertainties in the market, executives are turning more often to the board for guidance. Take Comcast, for example — it had a tough decision to make in whether to acquire a big television company, but it has a lot of smart people in the boardroom dedicated to the company who can serve as great strategic partners in making a decision like that.

Also, and somewhat ironically, what has strengthened the partnership function is the initiative of organizations like the Council of Institutional Investors and the New York Stock Exchange and Congress to strengthen the monitoring function. The impact of putting stronger, more independent-minded people in the boardroom has been to enhance the board’s ability to act in strategic collaboration with top management.

As Google disclosed in its IPO document, the dual-class structure will make it easier for its management team to follow the long term, to be innovative. True, investors will have little ability to influence strategic decisions. But, to put this affirmatively, it gives directors more obligation to work with top management without being quite so policed by outside owners, regulators, and so on. It opens up the opportunity for boards to work with top management to get the job done.

At companies with dual-class stock, it is more incumbent upon those in the boardroom to create that commitment, that obligation, that culture of leadership to work in collaboration with management because nobody is looking over their shoulders. By having a little bit more of a buffer, they have a little bit more opportunity to exercise that strategic partnership.

**William Bratton: Let dual-class companies list abroad**

William W. Bratton is the Nicholas F. Gallicchio Professor of Law at University of Pennsylvania Law School, where he is recognized internationally as a leading writer on business law. He is also co-director of the Institute for Law and Economics, a joint research center of the Law School, the Wharton School, and the Department of Economics at the University of Pennsylvania.

Dual-class stock was a big issue in the 1920s, when a lot of companies with no-vote common went public. The investment community back then had the same policy discussions on the topic that we’re having today. The dual-class side won in the 1920s, but that result was reversed during the Depression. In 1940 the New York Stock Exchange adopted a one share, one vote rule. If you wanted to come to the NYSE to get liquidity, it was one share, one vote, period. Well, not quite that. There were some exceptions: if you were a big enough listing you could turn the exchange’s head and get a waiver, as happened when Ford Motor went public in the 1950s. But basically for 40 years it was one share, one vote.

The one share, one vote consensus fell apart during the takeover era of the 1980s. Defensive, dual-
class recapitalizations started to occur. One share, one vote companies wanted to become takeover proof, so they left the NYSE to go to the Nasdaq or the American Exchange, both of which did permit dual class. Pressure built up on the NYSE, and in 1984 it suspended enforcement of its rule when GM threatened to leave for the Nasdaq because it wanted to issue low-vote common to Ross Perot in acquiring his company. The SEC tried to get the exchanges back into line, but they could not agree on a common approach. So the SEC adopted a rule called 19c-4. Some remember that rule as an attempt to return to one share, one vote, but what it really prohibited was dual-class common conversions: if you were already publicly traded on a one share, one vote basis, converting to dual class was forbidden.

Is there any way to turn back the clock to 1940? Unfortunately, no. Back in 1940 things were very different. Market participants were much more comfortable with flat-out prohibitions and were ready to draw bright lines. They were ready to choke off a deal in order to keep a clean market. And they could do so in an isolated national economy. Today we operate globally and regulatory issues don’t admit of easy yes and no answers. We accordingly look to disclosure, fiduciary law, and governance institutions to keep agency costs down at dual-class companies.

For myself, I would have no problem with turning back the clock to 1940 to return to one share, one vote. But since that can’t be done, what I would favor is forbidding the listing of new dual-class companies on U.S. exchanges. You want to be dual? Then list abroad, and sacrifice some of the yield on your IPO as information asymmetries negatively impact your price.

Vice Chancellor John Noble: The shareholder has fewer options

The Honorable John W. Noble has been a vice chancellor of the Delaware Court of Chancery since November 2000. Following law school at the University of Pennsylvania he served as a federal district court law clerk and then practiced with Parkowski, Noble & Guerke P.A., in Dover, Del.

While many of the other accountability or take-over-restrictive devices have come into question as to how well they’ll survive and how good of a job they do in protecting the founders’ personal interest, dual-class stock seems to continue to offer that option. So this may have a lot to do with why this topic is going to continue to have a fair amount of debate.

One of the questions that comes to mind is: what are the controls in a dual-class setting to drive or encourage good governance? A major risk is that centralized control allows the extraction of private benefits for the controllers, at a cost that is imposed disproportionately on the broader shareholder base. In this setting one can naturally have skepticism about board independence. Even though to some extent a dual-class setting is similar to a company with a large majority shareholder, the most obvious difference is that with a large shareholder we at least have the same proportionate economic shareholding interest. Concerns about proxy fights, losing votes at the shareholders’ meetings, simply aren’t a real consideration in a dual-class company. It seems, instead, that the general shareholder is left to disclosure, to the fiduciary duties that are imposed upon the directors of these enterprises through the common law, and to various public restrictions — “sham-ing” being one of them.

Duties of care and loyalty are important, and eventually they will perhaps rein in out of control controllers. But without effective voting control, the shareholder has fewer options. As has been pointed out, you can have wonderful corporate management in a company with dual-class stock, but it depends upon who the controllers are. Some will likely find the opportunity to take advantage of power — in the sense that absolute power corrupts absolutely — irresistible.

I draw something of an analogy to our alternate entities, limited partnerships and the like, where our law allows for the elimination of fiduciary duties. That’s not true in the dual-class setting, but I wonder if the rethinking of using dual-class stock is an effort to get the “benefits,” if you can call them that — and I’m not taking a position on that — of private ordering and trying to squeeze as much out of that notion as one can in what otherwise would be a publicly traded corporation subject to all kinds of constraints and conditions that we’re familiar with.
Extreme Governance:  
An Analysis of Dual-Class Firms in the United States

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Extreme Governance: 
An Analysis of Dual-Class Firms in the United States

ABSTRACT

We construct and analyze a comprehensive list of dual-class firms in the United States and use this list to investigate the relationship between insider ownership and firm value. Our data has two useful features for this valuation analysis. First, since dual-class stock separates cash-flow rights from voting rights, we can separately identify the impact of each. Second, we address endogeneity concerns by using exogenous predictors of dual-class status as instruments. While other data sets have provided one of these features, our data set is the first to provide both. In single-stage regressions, we find strong evidence that firm value is increasing in insiders’ cash-flow rights and decreasing in insider voting rights. In instrumental-variable regressions, the point estimates remain the same sign and magnitude, but the significance levels are lower.
1. Introduction

In recent years, researchers have demonstrated the powerful role of shareholder rights. The stream of research on this topic finds that the strength of shareholder rights at a company is associated with stock returns, valuations, operating performance, the frequency of value-destroying mergers, and pay-for-performance sensitivity. While debates exist on the proper measurement of shareholder rights, virtually all authors consider anti-takeover provisions to be among the most important restrictions of these rights. Nevertheless, all of these recent papers have ignored the most extreme example of anti-takeover protection: dual-class stock. About six percent of the publicly-traded companies in the United States have more than one class of common stock, and these companies are virtually immune to a hostile takeover. In this paper, we construct the first comprehensive panel of these companies and analyze the determinants and valuation effects of dual-class status and ownership structure.

In the typical dual-class company, there is a publicly traded “inferior” class of stock with one vote per share and a non-publicly traded “superior” class of stock with ten votes per share. The superior class is usually owned mostly by the insiders (managers and directors) of the firm and causes a significant wedge between their voting and cash-flow rights. In many cases, this wedge is sufficient to provide insiders with a majority of the votes despite their claims to only a minority of the economic value. The other forms

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2 In addition to the papers cited above, see Bebchuk, Coates, and Subramanian (2002), Gillan, Hartzell, and Starks (2003), Bebchuk and Cohen (2005), and Cremers and Nair (2005).
3 Some firms have more than two classes of common stock. To keep with the traditions of this literature, we refer to all multi-class firms as “dual class.”
of anti-takeover protection – poison pills, staggered boards, golden parachutes – are no match for the power of dual-class stock.

Past studies of dual-class stock in the United States have focused on subsets of dual-class firms at the time of the creation of their inferior class, the time immediately following their IPO, the atypical cases where both share classes trade, or as a subset of “family-controlled” firms. There are no papers analyzing a panel of all dual-class firms – perhaps because the identification of these firms is highly labor intensive and has only become feasible with the recent availability of electronic documents from the SEC. In this paper, we fill this gap in the literature by identifying and analyzing a comprehensive list of dual-class companies from 1995 to 2002.

The paper has three sets of analyses, discussed respectively in Sections 2, 3, and 4 of the paper. First, from the SEC disclosures, we code the insider holdings for all dual-class firms for both classes of stock. From these data, we can calculate the cash-flow rights and voting rights for all insiders, and summarize the ownership structure at dual-class firms. Second, by using this comprehensive list of firms – both dual-class and single-class – we can analyze the determinants of dual-class status, and provide insight into why firms choose this extreme form of governance. Finally, we exploit the difference in insiders’ cash-flow rights and voting rights to shed light on the relationship between insider ownership and firm valuation. The first two sets of analyses are

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5 Smart and Zutter (2003), Smart et al. (2006).
8 To our knowledge, the only other paper making an attempt at a comprehensive sample is the unpublished work of Zhang (2003). Zhang’s paper has a somewhat different focus than ours. He uses a single cross-section in 1995 (slightly smaller than our 1995 sample) and does not analyze the determinants of dual-class status nor attempt to control for self-selection or endogeneity in the valuation analysis.
essentially descriptive and confirmative of previous papers. The findings of these descriptive studies are crucial inputs for the valuation analysis, which we consider to be the main contribution of the paper. The details of all these analyses are discussed below in more detail.

In Section 2, we find that about six percent of all Compustat firms are dual-class, comprising about eight percent of the market capitalization of all firms. For about 85 percent of dual-class firms, there is at least one untraded class of common stock, and this untraded class almost always has superior voting rights to the traded class. As pointed out by Smart and Zutter (2003) using a sample of dual-class IPOs, the most common structure is for superior shares to have ten votes per share, while inferior shares have one vote per share. We confirm this finding in our comprehensive sample. On average, we find that insiders have approximately 60 percent of the voting rights and 40 percent of the cash-flow rights in dual-class firms. For almost 40 percent of the dual-class firms, insiders have more than half of the voting rights (thus providing effective control) but less than half of the cash-flow rights. To reflect the stark separation of economic ownership and voting control in these firms, we denote them as the “separation sample” and give them special attention in the later analysis.

In Section 3, we investigate the determinants of dual-class status. These tests follow a line of research begun by DeAngelo and DeAngelo (1985), with contributions by Lehn et al. (1990), Taylor and Whittred (1998), Field (1999), Amoako-Adu and Smith (2001), and Smart and Zutter (2003). Building upon the work of these authors, we extend the sample of firms and use the results as the first-stage of the valuation analysis that follows. Most dual-class firms chose their structure prior to their IPO. For the pre-IPO
owners, the dual-class structure is likely to have both benefits and costs. These benefits, typically called “private benefits of control” in the literature, can include both pecuniary and non-pecuniary components. The costs would occur if the new owners of inferior voting stock are willing to pay less for the same cash-flow rights, either because they expect direct expropriation or because they expect weaker shareholder rights to be associated with weaker performance. Thus, we hypothesize that dual-class status should be more prevalent when private benefits are high and perceived costs are low.

To test this hypothesis, we identify proxies for these costs and benefits and we find several variables that are predictive of dual-class status. All of these predictive variables are measured at the time of a company’s IPO: the level of sales as compared to other IPO firms in the same year, the number of pre-existing firms in the same metropolitan area, the total amount of sales among pre-existing firms in the same metropolitan area, a firm’s inclusion in a media industry, and, the most powerful predictor, whether a person’s name appears in the firm’s name.

In Section 4, we use special features of our sample to analyze the relationship between ownership structure and firm value. This topic has inspired a long empirical literature, beginning with Morck, Shleifer, and Vishny (1988). They find that market value is related to insider ownership in a non-monotonic way: for the largest listed firms in 1980, market value is increasing in insider ownership over the range of zero to five percent and decreasing with insider ownership over the range of five to twenty-five percent. The authors hypothesize that this pattern occurs because that the positive incentive effect (from cash-flow rights) dominates for low levels of insider holdings, and then the negative entrenchment effect (from voting rights) dominates at higher levels.
The same qualitative pattern has been confirmed in various other studies: McConnell and Servaes (1990) use a more comprehensive sample of firms and find a similar non-monotonic relationship between ownership and $Q$; Holderness, Kroszner, and Sheehan (1999) find a similar pattern in firms listed in 1935. The relationship between inside ownership and firm value has also been explored outside the United States. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2002) look at firms in 27 developed countries and find that higher insider cash-flow rights by insiders is associated with higher firm value. Seifert, Gonenc, and Wright (2002) confirm these results using a larger sample.

One constraint in these studies is that the two separate forces – incentives and entrenchment – must be identified using only one variable – ownership. An analysis of dual-class companies offers a way around this problem. Since these firms have equity structures that break the link between cash-flow rights and voting rights, an analysis of dual-class firms allows one to separate the role of these two effects. Two recent papers exploit this separation with studies in the same spirit as our analysis. Lins (2003) examines the relation between firm value, voting rights, and cash-flow rights, for over 1000 companies in 18 emerging markets. He finds that firm value is lower when voting rights exceed cash-flow rights. Claessens et al. (2002) study 1300 firms from eight East Asian countries and find that firm value increases with the cash-flow rights of the largest shareholder but decreases when the voting rights exceed the cash-flow rights.

Empirical studies of valuation and insider ownership are always subject to an endogeneity critique. Early work by Demsetz and Lehn (1985) pointed out that since ownership structure is one of many governance variables that are endogenously determined with firm value and performance, it will always be difficult to uncover the
underlying relationships with reduced-form empirical analysis. This argument has been repeated many times, most forcefully by Himmelberg, Hubbard, and Palia (1998) and Coles, Lemmon, and Meschke (2005).

In our analysis, we use dual-class shares to disentangle the incentive and entrenchment effects while also dealing with this endogeneity critique. In particular, the analysis of the determinants of dual-class status (Section 3) provides a first-stage regression for the key ownership variables; these first-stage results can be used for two-stage regressions that adjust for either sample-selection (Heckman regressions) or endogeneity (IV regressions). In the single-stage regressions, we find strong evidence that firm value is positively associated with insiders’ cash-flow rights and negatively associated with insiders’ voting rights. The point estimates are both economically large and statistically significant. The sample-selection regressions yield similar results. In the IV regressions, the point estimates remain the same sign and magnitude in almost all cases, but the significance levels are lower. The strongest results come from the separation sample: for these firms, all the evidence supports the positive effect of cash flow on valuation.

Section 5 concludes the paper with a summary and discussion of these results. An Appendix gives definitions for the key variables used in the regressions.

2. Data

2.1. The Dual-Class Sample

To build a comprehensive set of dual-class firms, we first construct a list of possible members – the “candidate sample” – and then we check the SEC filings for each
candidate to determine whether it is indeed a dual-class firm. We build the candidate sample using data from the Securities Data Company (SDC) (as amended by Jay Ritter), S&P’s Compustat, the Center for Research in Security Prices (CRSP), and the Investor Responsibility Research Center (IRRC).

The SDC candidates are taken from the Global New Issues Database, which tracks corporate new issues activity since 1970 and flags those issues that have a separate class of common stock. We supplement the SDC list with amendments from Jay Ritter’s website.9 To find companies with multiple traded share classes, we search the CRSP database for issues with identical six-digit CUSIPs but different two-digit extensions. A further group of candidates are identified from firms listed as dual-class in the IRRC’s Corporate Takeover Defenses texts from 1990 to 2002 (Rosenbaum 1990, 1993, 1995, 1998, 2000, and 2002).

Our final source of candidates comes from a comparison of Compustat and CRSP, as suggested by Zhang (2003). For each firm-year in Compustat, we match the monthly CRSP file for the month corresponding to the end of the fiscal year. We then compare the shares outstanding field in CRSP with the common shares outstanding field (DATA25) in Compustat. Since CRSP counts only the shares outstanding for a particular stock issue, and Compustat counts all shares for any class of common stock, a difference between these measures may be due to the existence of multiple classes. Thus, if these two share counts differ by more than one percent, we add that company-year to our candidate universe.

To go from the candidate sample to the actual list of dual-class firms – the “dual-class sample” – we first eliminate trusts, closed-end funds, ADRs, units, and REITs. 

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9 [http://bear.cba.ufl.edu/ritter/ipodata.htm](http://bear.cba.ufl.edu/ritter/ipodata.htm)
then examine the proxy statements and/or 10-Ks for every candidate. Under the Securities and Exchange Act of 1934, all firms are required to disclose the share ownership for each director, and for all officers and directors as a group. Following the past literature on this topic, we refer to this disclosed group of officers and directors as “insiders.” These disclosures give separate entries for the holdings in each class – usually as separate columns in a single table – so dual-class status can be definitively determined from these disclosures. After reviewing documents for every firm-year in our candidate sample, we construct the final dual-class sample. These procedures were designed in an attempt to capture all dual-class firms with at least one share class trading on a major U.S. exchange: NYSE, AMEX, or NASDAQ. While we did not check the proxies of all listed firms – only those in our candidate sample – we are confident that the dual-class sample is very close to comprehensive. To test this view, we randomly selected 200 firms from outside the candidate sample and checked their proxies. None of these 200 firms were actually dual class.

Once the dual-class sample is completed, the next step is to determine the insider ownership for each class of stock in every firm year. The SEC disclosures often combine the ownership of stock in the same table with ownership of options, warrants, deferred shares, and other purchase rights. We parsed the tables and footnotes to compute the common-stock ownership, excluding all options and other rights. Since the share classes sometimes have differing cash-flow rights, we also collected dividend data for all firms. First, we coded the dividend information contained in the 10-Ks by class for each firm and year. Second, we used CRSP to identify large, “special” distributions paid out to shareholders.
2.2. Summary Statistics

Table 1 summarizes our universe of companies. We include all Compustat firms except for trusts, closed-end funds, ADRs, units, and REITs. All firms are classified either as single-class or dual-class, with the latter group including all multi-classed firms identified by the procedures in Section 2.1, above. The dual-class sample size varies between a minimum of 362 (in 2002) and a maximum of 504 (in 1998). The single-class sample size varies between a minimum of 6345 (in 2002) and a maximum of 7619 (in 1997). Across all years, about 85 percent of the dual-class sample has at least one non-traded class. In the vast majority of these cases, the superior class is not traded.

Table 1 also gives the voting structure of the dual-class firms. The most common arrangement is a 10:1 structure in which the superior class has ten votes per share and the inferior class has one vote per share. To see how such structures affect the eventual ownership and control of the firms, Table 1 shows the fractions of cash-flow and voting rights held by the insiders. On average, the insiders of dual-class firms own a majority of the voting rights (about 60 percent) and a significant minority of the cash-flow rights (about 40 percent). Nearly all of these voting rights come from the superior voting class stock; less than fifteen percent of the insiders’ voting rights come from the inferior voting class.

In about one-third of all dual-class firms, the insiders have a majority of the voting rights \( VOTE > 0.50 \) but do not have a majority of the cash-flow rights \( CF < 0.50 \). These firms comprise a special case of the dual-class sample, since insiders have

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10 The number of “dual-class” firms with three or more classes varies between 17 and 28 firms over the sample period.
effective control over all corporate decisions, but have claims to less than half of the economic value. We classify these firms as the “separation sample.”

A more complete picture of the ownership structure of dual-class firms can be seen in Table 2, which shows a cross-tabulation of cash-flow and voting rights for each firm-year in the dual-class sample. For the majority of firm-years, insiders’ voting rights are higher than their cash-flow rights (entries below the 45 degree line), with few firms showing the reverse (entries above the 45 degree line). Entries in the bottom left quadrant are members of the separation sample.

Table 3 gives summary statistics for dual-class and single-class firms for the representative year of 2000. Both groups have about the same average level of assets and equity-market capitalization. Differences in size distributions become more apparent when we compare the medians. The median dual-class company has $482 million in assets versus $138 million for the median single-class company. Similarly, dual-class firms have a median market value of $295 million versus $100 million for single-class firms. Overall, dual-class firms comprise about six percent of the number of public companies and eight percent of the market capitalization.

Table 3 also shows that dual-class firms are significantly more levered than single-class firms, with significant differences in both the means (0.23 vs. 0.17) and medians (0.18 vs. 0.06) of the debt-to-assets ratio. This difference has several possible drivers. One possibility is that dual-class firms are reluctant engage in seasoned equity offerings (SEOs), for fear of diluting some of their control. Cronqvist and Nilsson (2005) find a similar reluctance for SEOs in family-controlled firms. Another possibility, suggested by Moyer, Rao and Sisneros (1992), is that debt is used as an alternative
control mechanism in dual-class firms. This finding raises the interesting question of whether dual-class firms possess other countervailing governance mechanisms such as outside directors (also suggested by Moyer, Rao, and Sisneros (1992)), family ties (as suggested by DeAngelo and DeAngelo (1985)), stronger pay-for-performance, or stronger monitoring by outside blockholders. We leave the analysis of this issue for future research.

Dual-class firms are, on average, significantly older than single-class firms, where age is defined as the time (in years) from the firm’s CRSP listing date. The average (median) age of dual-class firms in 2001 is 12.87 (7.21) years while the average (median) age for single-class firms is 9.60 (6.67) years. The most likely explanation for this difference is that dual-class firms are less likely to be acquired. The age difference is particularly striking considering the offsetting effect of IPOs, since the fraction of IPOs with dual-class stock was steadily climbing during our sample period. Since the IPO market is adding proportionally more firms to the dual-class sample, the seasoned dual-class firms must have an even greater age difference over their seasoned single-class counterparts. Finally, there are only small differences for the book-to-market ratio, both in means and medians.\footnote{For dual-class companies where only one class of stock trades, we compute market value by assuming that the non-traded stock has the same value per share as the traded stock. In the valuation analysis of Section 4, we discuss the sensitivity of our results to this assumption.} This univariate result does not hold up in multivariate analysis, as we will see in Section 4.

To get a sense for the industry concentration of dual-class stocks, we use the industry classification of Fama and French (1997) to place all stocks into one of 48 industry groups as of December 2001. We find that Communications, Business Services, Printing and Publishing, Retail, and Machinery are the five industries with the greatest...
number of dual-class firms in 2001. This distribution is different from the rest of the population of firms. Business Services is the largest industry for single-class companies, followed by Electronic Equipment, Trading, Pharmaceutical Products, and Retail. The predominance of communications and printing and publishing is not surprising. DeAngelo and DeAngelo (1985) were the first to suggest that the non-pecuniary private benefits of control may be high in media-related firms and hence may induce founders to establish a dual-class structure.

Our final set of summary statistics focus on the relationship between dual-class status and stock returns. While there is no a priori reason to expect any relationship between ownership structure and returns, several recent papers find that returns are related to other governance variables during our sample period [Gompers, Ishii, and Metrick (2003), Bebchuk, Cohen, and Ferrell (2008), Cremers and Nair (2005)]. Thus, it is logical to check whether any correlation exists in our sample. We begin by constructing portfolios: the dual-class portfolio includes all firm-months in the dual-class sample, and the separation portfolio includes all firm-months in the separation sample. The status of each firm is updated once per fiscal year, with all changes to the portfolios made in the following July. For each portfolio, we compute both value-weighted and equal-weighted monthly returns from July 1995 to June 2003. We then estimate the performance-evaluation regression

$$ R_t = \alpha + \beta_1 * R_{MRF_t} + \beta_2 * SMB_t + \beta_3 * HML_t + \beta_4 * Momentum_t + \epsilon_t, $$

(1)
where $R_t$ is the excess return to the relevant portfolio (dual-class or separation, equal-weighted or value-weighted) in month $t$, $RMRF_t$ is the month $t$ value-weighted market return minus the risk-free rate, and the terms $SMB_t$ (small minus big), $HML_t$ (high minus low), and $Momentum_t$ are the month $t$ returns to zero-investment factor-mimicking portfolios designed to capture size, book-to-market, and momentum effects, respectively.\footnote{This model extends the Fama-French (1993) three-factor model with the addition of a momentum factor (Carhart (1997)). All factor returns were downloaded from Ken French’s website: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/} Although there is an ongoing debate about whether these factors are proxies for risk, we take no position on this issue and simply view the four-factor model as a method of performance attribution. Thus, we interpret the estimated intercept alpha as the abnormal return in excess of what could have been achieved by passive investments in the factors.

Table 4 summarizes the results. For both portfolios, the value-weighted alphas are negative and the equal-weighted alphas are positive. While some of these alphas are economically large, the limited power of these regressions prevents strong inference. Of the four estimated alphas, only the equal-weighted alpha for the dual-class portfolio is significant, and only at the ten-percent level. Given the inconsistent signs and weak significance, we conclude that there is no clear pattern to the abnormal returns.

Our finding of no abnormal returns differs from the findings of other recent papers in the corporate-governance literature. This difference requires some comment, so we offer two interpretations. First, it could be that the results of these earlier papers [Gompers, Ishii, and Metrick (2003), Bebchuk, Cohen and Farrell (2008), Cremers and Nair (2005)] are period-specific or are driven by some omitted factor that is correlated with their respective governance measures but not with dual-class status. Alternatively, it
is possible that dual-class status was fully incorporated into stock prices by the beginning of our sample period, while the governance measures used in the other papers were not fully incorporated into prices.

While both of these explanations are plausible, we lack the evidence to draw any strong conclusions. On intuitive grounds, we are inclined towards the second explanation. Dual-class stock was a hotly debated governance device during the 1980s and 1990s, with many academic papers and regulatory scrutiny. By the beginning of our sample period in 1995, investors would have had substantial information about dual-class companies and a significant amount of time to digest this information. Given the roughly zero abnormal returns in the subsequent years, we can say that the circa-1995 investors knew what they were buying. In contrast, the shareholder-rights index of Gompers, Ishii and Metrick (2003) is an amalgam of many disparate governance provisions, most of which had limited empirical evidence and regulatory attention. It seems possible that the market would have had far less information about the components of this arbitrary index than about the salient feature of dual-class stock.

3. The Determinants of Dual-Class Status

Using our classification of firms, we can analyze the determinants of dual-class status. This exercise is useful for two reasons. First, we would like to go beyond the univariate comparisons of Table 3 to get a more sophisticated view of the multivariate correlates and determinants of dual-class status. Second, in the valuation analysis of Section 4, we will need to have first-stage regressions for both sample-selection and endogeneity correction, and the analyses here can serve that purpose.
Why would a firm choose to have a dual-class structure? Take the typical case of a firm that chooses a dual-class structure at IPO. Before the IPO, the firm is completely controlled by managers, venture capitalists, and other private investors. Some of these shareholders are expecting to remain active in the firm after the IPO (“insiders”), while others (“investors”) are hoping to sell their shares and disengage. The decision to go public often involves negotiations between these two groups, with the insiders trying to preserve some private benefits of control and the investors trying to maximize the post-IPO share price. Assume, for now, that a single-class structure (one share, one vote) would indeed maximize the share price. Then, while a dual-class structure would preserve more of the private benefits of control for insiders, this control would come at some cost to the investors, since the post-IPO price would be lower. If the private benefits of control are larger than the aggregate reduction in share value, then there is scope for the insiders to bargain with investors and obtain a dual-class structure upon the IPO.\(^{13}\)

For what kinds of firms would we expect to see large private benefits of control? To answer this question, for each year of the sample we estimate a probit regression of

\[
DUAL_{it} = BZ_{it} + u_{it}
\]

(2)

where \(DUAL_{it}\) is a dummy variable equal to one if firm \(i\) is a dual class firm in year \(t\), and 0 otherwise. \(Z_{it}\) is a vector of firm, industry, or market characteristics at the time of firm \(i\)’s IPO. We include the following variables as components of \(Z\). All of these variables

\(^{13}\) See Coates (2001) for a detailed exposition about the motivations of dual-class status.
are measured for the year prior to firm i’s IPO, so each $Z_i$ vector remains constant throughout the sample period.

*Industry:* Since private benefits of control are likely to vary across industries, we include dummy variables for each of the industries as defined by Fama and French (1997) [FF]. We follow the related literature and remove all financial firms (FF industries #44, #45, and #47) and regulated firms (FF industry #31) from the sample. Thus, we are left with dummy variables for the 44 remaining FF industries, which represents between 92 and 95 percent of the full sample across different years.

*Media:* A dummy variable equal to one if the firm was a “media” company in its IPO year, and a zero otherwise. We define media companies as those belonging to SIC codes 2710-11, 2720-21, 2730-31, 4830, 4832-33, 4840-41, 7810, 7812, and 7820. Note that this definition overlaps imperfectly with two industries as defined by Fama and French (1997), communications and printing/publishing, so the *Media* variable is not perfectly correlated with the industry dummies. As documented by DeAngelo and DeAngelo (1985), Field (1999), and Smart and Zutter (2003), media firms are more likely to have dual-class status. This seems logical, since control of a media company – newspaper, television network, etc. – provides many opportunities for private benefits.

*Name:* One possible signal that insiders place a high value on the private benefits of control is if the company is named for one of the insiders. We construct a noisy measure of this naming congruence by examining the company names at the time of IPO for all
13,000+ firms that ever appear in the Compustat sample (both single class and dual class) during our sample period and coding the Name dummy variable equal to one if the firm’s name at IPO includes a person’s name in it.\textsuperscript{14} While this Name variable is new, the result that family ownership is predictive of dual-class status is shown in other samples by DeAngelo and DeAngelo (1985), Field (1999) and Amoako-Adu and Smith (2001).

\textbf{StateLaw:} Dual-class stock is a powerful anti-takeover protection. Since this protection may be less valuable for companies incorporated in states with anti-takeover laws, we include the StateLaw anti-takeover index from Gompers, Ishii and Metrick (2003).

\textbf{SalesRank:} We hypothesize that private benefits of control are stronger for firms where the founders are still active. It would be prohibitively time-consuming, if not impossible, to determine founder status at IPO for all 13,000 firms in our sample. One plausible proxy for founder status is the age of the firm (time since first incorporation), but this data is also noisy and difficult to collect. As an alternative proxy for firm age (and thus for founder status), we use SalesRank, the percentile ranking of the IPO-year sales of the firm relative to other firms with the same IPO year. The reasoning here is that, other

\textsuperscript{14} To avoid any biases in the construction of this variable, we employed three research assistants (RAs) who had not worked on any other part of the project. Each of these RAs coded the full sample of firms (both single-class and dual-class, with the full sample given in alphabetical order within industries) on their own, with the instruction to use their judgment as to whether the firm name included a person’s name. This name does not have to be a founder’s name, since founder’s name is unknown; any name will do. Thus, “Bob’s Sporting Goods” is just as good as “Trump Casinos.” Then, for any firm where the RAs’ judgments were not unanimous, they discussed their choices and tried to reach unanimity. The hard cases mostly occur when a proper name is included that could either represent a place name or a person’s name. If there was still disagreement after the discussion, the team did additional research using library databases, internet search engines, company websites, and SEC filings to attempt to learn the origin of the company’s name at IPO. If this search failed to provide conclusive evidence, then the RAs voted their beliefs and the majority judgment was used to code the variable. This majority rule was required for less than 2 percent of the sample. While the final variable is certainly a noisy measure, it is untainted by knowledge about dual-class status.
things equal, sales at the time of the IPO is likely to be positively correlated with firm age, which would then be correlated with founder status. Thus, we expect that SalesRank (0 = lowest, 100 = highest) would have a negative coefficient in the estimation of (2).

**ProfitRank:** We measure ProfitRank analogously to SalesRank, by computing a percentile ranking (0 = lowest, 100 = highest) in the IPO year relative to other firms in the same IPO year. Profits affect both the private benefits of control and the private costs of control. Private benefits of control are likely to be positively correlated with cash flow and profitability, as free cash flows can be diverted towards pet projects and excess compensation. Since investors recognize this relationship, they are likely to demand control discounts that are positively correlated with profitability, thus increasing the private costs of control. Ultimately, the net effect of these benefits and costs is an empirical question, which we examine through the coefficient on ProfitRank in (2).

**%Firms and %Sales:** In recent years, some high-profile cases of corporate fraud have occurred at large firms that were major employers in their geographic region. Firms such as Adelphia and HealthSouth have highlighted the phenomenon of CEOs playing local benefactor with corporate funds. One possibility is that private benefits of control are bigger when insiders have the opportunity to be the major employer in their region: that is, when the firm is the “only game in town.” In this case, we would be less likely to observe dual-class status the more other firms are located in the same region. Furthermore, firms with an important local presence may use dual-class status as a promise to local authorities that the firm will resist unsolicited takeovers in order to honor
implicit contracts with local governments and other stakeholders.\textsuperscript{15} An alternative possibility is that regions crowded with large firms allow more scope for local M&A activity, and dual-class status could serve as an anti-takeover protection. In this case, we would be more likely to observe dual-class status the more “large” firms are located in the same region. To measure the net effect of these forces, we use two variables, $\%Firms$ and $\%Sales$. $\%Firms$ is the percentage of all Compustat firms located in the same Metropolitan or Micropolitan Statistical Area (MSA) as firm $i$ in the year before firm $i$’s IPO.\textsuperscript{16} $\%Sales$ is defined analogously using sales: the percentage of all Compustat sales by firms located in the same Metropolitan or Micropolitan Statistical Area (MSA) as firm $i$ in the year before firm $i$’s IPO. Under this construction, if firm $i$ is the only Compustat company in its MSA, then $\%Firms$ and $\%Sales$ will both be equal to zero.

Sales/RegionSales: As an alternative measure of the “only game in town” effect, we use the ratio of a firm’s sales to the sales of all firms in the same region. This measure is a proxy for the firm’s “share of the local pie,” while the Sales% measure (discussed above) is a proxy for the “size of the local pie.” Under this construction, if firm $i$ is the only Compustat company in its MSA, then Sales/RegionSales will be equal to 100 percent.

Of course, there are many other variables that might be correlated with dual-class status, several of which have been used by previous authors: for example, CEO salary (Field 1997) and quality of the investment bank Smart and Zutter (2003). In each of

\textsuperscript{15} The same mechanism – a promise to local authorities to resist takeovers – could also explain a positive correlation between dual-class status and the Name variable, since the value of the promise would be greater when attached to a person’s name and reputation.

\textsuperscript{16} The MSA location of the firm is its headquarters location, as given by Compustat. For firms in counties not included in an MSA, we use the county as the geographic unit.
these cases, however, it is not possible for us to obtain a comprehensive sample of these data for all firms at the time of their IPO. Thus, we restrict ourselves to the variables for which we can find either comprehensive data or good proxies.

The results of our probit estimations of (2) are given in Table 5. Since most of the firms remain the same from year to year and most variables are slow-moving, these annual cross-sectional estimates are highly correlated. For a summary measure (last column of Table 5), we compute pooled estimates, where each firm is included in the regression only for the first year it appears in the sample, and then again in any year where its dual-class status has changed.

There are only 159 changes of dual-class status across the seven years of the sample period, so this pooled regression is dominated by firms with only one appearance in the sample. Some readers may wonder why we did not focus more attention on these 159 firms that switched status. The main problem is that status changes are not exogenous, and so it is difficult to draw general conclusions that are free of endogeneity concerns. In the valuation analysis of Section 4, we will handle endogeneity problems by using a two-stage regression with regression (2) as the first stage. It would not be possible to use this regression to adjust for endogeneity of changes, because (2) is designed to predict dual-class status at the time of the IPO, not changes in this status following the IPO. While one could try to construct a different regression to predict these changes, the 159 examples in our data are insufficient for a powerful test.

In the pooled regression, we find significant results for five coefficients. Consistent with the intuition sketched above, the coefficient on Name is positive and significant at the one-percent level, the coefficient on Media is positive and significant at
the five-percent level, and the coefficient on SalesRank is negative and significant at the one-percent level. For the %Firms and %Sales variables, the signs of the coefficients are significant in opposite directions: negative for %Firms and positive for %Sales. One interpretation of this result is consistent with the notion that the “local benefactor” effect dominates when there are few firms (so it is more likely to choose dual-class status when there are few other local firms), while the anti-takeover effect dominates when there are more potential acquirers (so it is more likely to choose dual-class status when there are large local firms).

4. The Valuation of Dual-Class Firms

4.1. Estimation Methods

In this section, we analyze the valuation of dual-class firms, with a focus on the relationship of firm value with dual-class status, cash-flow rights, and voting rights. The theoretical work on this topic finds no clear relationship between dual-class structure and firm value [Grossman and Hart (1988), Harris and Raviv (1988)], so researchers must turn to the data. Our analysis in this section is the first attempt to estimate these relationships using a comprehensive panel of dual-class firms.

Our valuation measure is industry-adjusted Tobin’s $Q$. Despite its limitations, average $Q$ has been the workhorse of large-sample valuation studies since Morck, Shleifer, and Vishny (1988). We follow Kaplan and Zingales’ (1997) method for the computation of $Q$, as described below in Section 4.1.1. Industry-adjustments are done from the median $Q$ in the 48 industries classified by Fama and French (1997). Then, for each month in our sample, we estimate
\[ Q'_{it} = a + bX_{it} + cW_{it} + e_{it}, \] 

(3)

where \( Q'_{it} \) is some transformation of industry-adjusted \( Q \) (=\( Q_i \) minus value-weighted industry \( Q \)) for firm \( i \) in month \( t \), \( X_{it} \) is a vector of insider variables (dual-class status in some specifications, cash-flow rights and voting rights in other specifications) and \( W_{it} \) is a vector of firm characteristics. As elements of \( W \), we follow Shin and Stulz (2000) and include the log of the book value of assets and the log of firm age as of December of year \( t \). Morck and Yang (2001) show that S&P 500 inclusion has a positive impact on \( Q \), and that this impact increased during the 1990s; thus, we also include a dummy variable for S&P 500 inclusion in \( W \). While we are interpreting \( Q \) as a valuation measure for assets in place, the numerator of \( Q \) will also reflect the capitalized value of growth options. As an attempt to control for these options, we include the ratio of R&D to sales, the ratio of capital expenditures to assets, and the ratio of advertising to sales as additional elements of \( W \). Finally, since our measure of \( Q \) may be sensitive to capital structure, we also include the book ratio of debt to assets in \( W \). Note that many of these variables are likely to be endogenously determined with \( Q \), and thus their coefficient estimates in (3) would be biased. Since we are not interested in the interpretation of the coefficients on these controls, such bias is not a problem for our analysis.

In a perfect world, we could estimate an OLS pooled time-series cross-sectional regression of (3) with all firms and all years. There are five problems with this simple pooled regression. The first problem is that empirical estimates of \( Q \) are noisy measures of the true \( Q \), and this noise is not symmetric around the mean. This problem can be
alleviated by using transformations of $Q$ or robust estimation methods, as is discussed in Section 4.1.1. The second problem is that the error terms in (3) are correlated in each cross-section. This problem can be solved by clustering the cross-sectional observations or by taking the time-series average of cross-sectional regression coefficients (Fama and MacBeth (1973)). These methods are discussed in Section 4.1.2. The third problem is that these cross-sectional estimates are not independent across time. We can adjust for this dependence using either the “double-clustering” approach of Thompson (2006) or by combining techniques developed by Andrews (1993) and Chordia et al. (2004). These methods are discussed in Section 4.1.3. The fourth problem is that we may have sample-selection bias when we estimate (3) only for the subsample of dual-class firms. We handle this problem using the methods of Heckman (1979), as is discussed in Section 4.1.4. Finally, the endogeneity of ownership structures is a perennial problem in empirical studies of ownership and value. In Section 4.1.5, we discuss how we handle endogeneity concerns by using instrumental variables from regression (2).

4.1.1 – Problem #1: Measurement Error in $Q$

As a valuation measure, average $Q$ is an imperfect but frequently used choice. Ideally, we would measure $Q$ as Tobin intended – the ratio of the market value of assets to their replacement cost – but data limitations render estimates of replacement cost to be very imprecise for a sample of this size. Instead, we follow the now-common procedure introduced by Kaplan and Zingales (1997). For each firm $i$ and month $t$ we compute
\[ Q_{it} = \frac{[BV_{it} \text{ Assets} + MV_{it} \text{ of Common Stock} - BV_{it} \text{ of Common Stock} - \text{Deferred Taxes}_{it}]}{BV_{it} \text{ Assets}}, \] (4)

where BV is “book value” and MV is “market value.” The MV of equity is measured at the end of each month, and the accounting variables are measured in the current fiscal year for December and the previous fiscal year for January through November. The MV of equity for dual-class firms with non-trading classes is calculated using shares outstanding from proxy statements and assuming equal prices across classes.\(^{17}\)

Like all estimates of \( Q \), ours is subject to measurement error. The accounting data in the denominator of (4) is of particular concern, since book values of some intangible assets can often be quite different from their “true” replacement cost. This is less of a problem for the numerator, since we can capture the market value of intangible assets through the MV of common stock term. Measurement error in the denominator of (4) causes errors in \( Q \) to be right-skewed, with some very extreme outliers. While measurement error in the dependent variable does not cause bias, it does inflate the residuals and standard errors, making inference more difficult. To the extent that such measurement error is correlated within industries, our use of industry-adjusted \( Q \) can provide some mitigation. Nevertheless, the most extreme outliers tend to be driven by firm-specific measurement error, so further steps are necessary.

\(^{17}\) On average, non-traded stock makes up a small part of capital structure, so this assumption does not have a significant impact on our results. As a robustness check, we made an alternative assumption that the non-traded superior shares were worth 10 percent more than the traded inferior shares, with no qualitative effect on any of the results. Given the results of Nenova (2000), ten percent is certainly an upper bound on this premium. The premium for the superior non-traded class is very unlikely to be negative, since the superior class can be freely converted to the (traded) inferior class in most companies.
To reduce the measurement error, we estimate three different variations of (3) for every variation of $X$. The first variation uses robust regression to deal with the measurement error by estimating a median regression with industry-adjusted $Q$. We use the notation $Q'$ to represent industry-adjusted $Q$, which is calculated as $Q - \text{industry } Q$. The second variation uses a log transformation, which we write as $\ln Q'$ and compute as $\ln Q - \ln \text{industry } Q$. We then use $\ln Q'$ as the dependent variable and estimate (3) using OLS. This log transformation is one natural way to reduce the influence of outliers, but any concave function could serve a similar purpose. The third variation is also estimated by OLS and uses $-1/Q'$ as the dependent variable, where $-1/Q'$ is calculated as $-[1/Q - 1/(\text{industry } Q)]$. In this case, the measurement error is in the numerator, which induces much less noise than its inverse. As shown below, all three of these robust methods give quantitatively similar results.\footnote{To be mathematically precise, we should write $\ln Q'$ as $(\ln Q)'$, since the industry adjustment occurs after we take the natural log. For notational convenience, we drop the parentheses in the text. The same disclaimer holds for $-1/Q'$, since the industry adjustment occurs after the inverse function.} In contrast, in untabulated results we also replicated all of our tests using the baseline $Q$ as given in equation (4). As expected, the standard errors were much larger than in the three other variations, and none of the results were statistically significant.

4.1.2 – Problem #2 – Cross-Sectional Dependence

In a cross-sectional regression of firm-level returns on exogenous characteristics, the error terms are correlated, with an unknown correlation structure. Since the numerator of $Q$ is market value, and past returns are a component of market value, our regression in (3) will also have some unknown cross-sectional dependence. With a long-enough time series, this problem can be handled by clustering observations within years.
Asymptotically, such clustering is equivalent to the method of Fama and MacBeth (1973) (FM): estimate a separate regression for each cross-section, and then perform inference on the time-series mean and standard deviation of the cross-section coefficients. In one set of regressions, we follow the FM procedure, with some necessary adjustments, as explained below in Section 4.1.3.

It is important to note that all inference in these regressions requires the assumption that each set of cross-sectional regression coefficients is drawn from the same distribution. In other words, the relationship between valuation and ownership structure must be stable over time. It is not possible to explicitly test this assumption: the main reason we need FM in the first place is that we cannot estimate the standard errors of any given set of cross-sectional coefficients. Nevertheless, the approximately “zero” abnormal returns of Table 4 give us some confidence that the relative valuation of dual-class vs. single-class stocks is relatively stable over our sample period.

4.1.3 – Problem #3: Time-Series Dependence of Coefficients

The FM procedure was designed to handle cross-sectional regressions of stock returns on characteristics. For return regressions, it is reasonable to assume that the monthly coefficients are independent. For \( Q \) regressions, this assumption would be too strong; at the very least, any measurement error in \( Q \) is likely to be persistent. Thus, to apply FM correctly, we must adjust for time-series dependence in the estimated cross-sectional coefficients. The typical solution to this problem is to estimate a first-order autoregressive model for each coefficient and then use the estimated autoregression coefficients to adjust the FM standard errors. Petersen (2005) demonstrates that this
procedure is flawed when there is small-sample bias in the autoregression coefficients. In many applications, this small-sample bias is unavoidable, since researchers must use annual data over limited time periods. In our application, $Q$ can be estimated monthly (albeit with high levels of persistence), resulting in a substantial number of observations. Specifically, we begin by estimating monthly cross-sections of (3). Then, to account for time-series correlation in our monthly regression coefficients, we estimate an AR(1) process for each regression coefficient, $\beta_k$, as

$$\beta_{kt} = \mu + p\beta_{k,t-1} + \epsilon_{kt},$$  \hspace{1cm} (5)$$

where $|p| < 1$ and $\epsilon_{kt}$ is a white noise process, for $t = 1, \ldots, T$. This least-squares estimator of $p$ is known to be downward-biased. If $T$ is “too small,” then it is not possible to correct this bias. For large enough $T$ – as we have here – Andrews (1993) provides a method for using least-squares estimates of $p$ to produce median-unbiased estimates. We use Table 2 of Andrews (1993), which is based on 100 time-series observations. Linear interpolation between table entries is reported to be quite accurate, so we use this method.

Given our median unbiased estimate of $p$, we calculate our corrected standard error of the mean coefficient as:

$$CSE = \sigma \sqrt{\frac{1}{T} + \frac{2p}{(1-p)T} - \frac{2p(1-p^T)}{(1-p^2)T^2}},$$  \hspace{1cm} (6)$$

where $\sigma^2$ is the time-series variance of the coefficients and $T = 96$. This formula is derived in Chordia et al. (2004). Under an AR(1) assumption, this method, which we call
“AR-corrected” standard errors, will provide the most efficient estimates. If we drop the AR(1) assumption, then we can still compute robust standard errors that allow for arbitrary correlations of error terms between firms (within each cross-section) and over time (for each firm). Thompson (2006) provides properties for this “double-clustering” technique and shows how it can be easily computed in standard statistical packages. We refer to these standard errors as “Thompson-corrected”.

Note that these corrections for time-series dependence require many time-series observations. For the valuation regressions, we are able to do this, since the numerator of Q changes every month. In contrast, it is not possible to use these techniques on annual or quarterly data over our sample period. This limitation makes it impossible to obtain unbiased estimates of standard errors for the relationship between ownership structure and operating performance.

4.1.4 – Problem #4: Sample-Selection Bias

In Section 4.2.1, we use all firms in the sample, with dual-class status serving as a right-hand-side variable. These regressions do not have any sample-selection bias. In Section 4.2.2, however, we use only the dual-class firms, and in Section 4.2.3, we use only the firms in the separation sample. While these estimations can provide useful results for their respective samples, our ability to draw inference for all firms is clouded by the possibility that dual-class firms are different from single-class firms, with these differences inducing different relationships between ownership and firm value. For example, suppose that there is no significant relationship between ownership and value among all firms, but there is such a relationship for firms in the media industries.
Perhaps media industries require a “strong hand” of leadership (higher benefits of dual-class ownership), and without this strong hand the firms tend to flounder. Then, since media firms are overrepresented among dual-class firms, in the dual-class sample we could find a positive relationship between value and insider voting ownership, but it would be incorrect to extend this finding to all firms.

We correct for the possibility of such sample selection by using the methods of Heckman (1979), with regression (2) serving as the selection equation. We cannot use median regression in this setting, so we rely on OLS. Furthermore, we cannot compute Thompson-corrected standard errors in this case, so we rely on the AR(1) assumption (discussed in 4.1.3, above) and compute only the AR-corrected standard errors.

For Heckman estimation to have good finite-sample properties, it is very helpful to have some first-stage regressors that can be properly excluded from the second stage. The first-stage regressors are given in Table 5. The exclusion restrictions will be discussed below in Section 4.1.5. Also, it is important to note that these methods can only adjust for sample-selection based on observable characteristics. If there is a selection bias on characteristics that are omitted from the selection equation then these methods will not be able to correct for it.

4.1.5 – Problem #5: Endogeneity

The endogeneity of ownership structure and firm value is a serious concern for regressions like (3). If firms choose ownership structures based in part on any other input into valuation, then the residuals in (3) would be correlated with the ownership variables, and the coefficient estimates will be biased. In particular, our concern here is that insiders
may perceive higher benefits for dual-class status when they simultaneously perceive that their company is “undervalued”, since dual-class status would then provide a powerful takeover deterrent and could preserve the private benefits of control. In this case, \( Q \) would be negatively correlated with dual-class status (and insider voting rights), and OLS estimation would be biased towards finding a negative valuation effect for insider voting rights.

In practice, the endogeneity problem is difficult to solve, since it is hard to find good instruments for ownership structure. In this case, our use of dual-class firms provides a good opportunity to find instruments, because the exogenous variables used in (2) have some explanatory power for the choice of dual-class structure, and may also be useful for ownership variables based on this structure. To be valid instruments, the variables excluded from the second-stage regression must be significantly correlated with the (possibly) endogenous ownership variables and be uncorrelated with the second-stage error term. When valuation measures are the dependent variables, it is difficult to identify valid instruments \textit{ex ante}. Prior empirical work has found many seemingly innocuous variables to be correlated with valuation. With few exceptions, we have no reason to believe that the regressors in (2) would be correlated with the residuals in (3), but we will perform overidentification tests to check the validity of this assumption. The exceptions here are \textit{MEDIA} variable and the MSA-level variables: \%firms, \%sales, and Sales/RegionSales. Since the media companies operate in markets with potentially high values for intangible assets, it is plausible that the \textit{MEDIA} dummy would be correlated with \( Q \). In our tests, we do indeed find that to be true, so we will include \textit{MEDIA} as a regressor in (3) and not use it as an instrument. Also, the work of Hong, Kubik, and Stein
(2005) suggests that the MSA-level variables may also be correlated with the residuals in (3). Our tests (discussed below) reject this concern, so we do include these variables as instruments.

Note that endogeneity problems are conceptually distinct from the sample-selection problems discussed above in Section 4.1.4. For example, even if the residuals in (3) are uncorrelated with the regressors, it could be the case that dual-class companies are not representative of all companies for the relationship between ownership structure and firm value. In this case, we would have a sample-selection problem without an endogeneity problem. Conversely, dual-class companies could be representative of all companies while ownership structure is endogenous for all companies. In this case, we would have an endogeneity problem without a sample-selection problem. In principle, it is possible to split the set of instruments, using one part for selection and one part for endogeneity. For our sample, however, we do not have enough explanatory power in our instruments to allow for both corrections at the same time. Thus, if both problems do exist, then the IV results can still allow for correct inferences, but only on the samples used for the estimation.

4.2. Results

4.2.1 – Full-Sample Results

We begin with the full-sample results. Table 6 gives the results of estimating (3) using a variety of specifications. The coefficients on the \( W \) vector are omitted from this and all other tables and are available by request from the authors. In Panel A, we give the single-stage regression results. The first five columns of show the results when a dual-
class status dummy variable is used as $X$: column (1) gives median-estimation results with $Q'$ as the dependent variable; the next two columns give OLS results with $\ln Q'$ as the dependent variable with AR-corrected standard errors (column 2) and Thompson-corrected standard errors (column 3); the next two columns gives OLS results with $-1/Q'$ as the dependent variable with AR-corrected standard errors (column 4) and Thompson-corrected standard errors (column 5). The coefficients on $DUAL$ are negative in all five of these regressions, but are only significant in the median regression shown in column 1.

In interpreting these results, it is important to realize that dual-class status does not have uniform implications for incentives and entrenchment. Some dual-class firms have only a small difference between insider cash-flow rights and voting rights, while others have a large difference. In the last five columns of Table 6, we use this difference, defined as $WEDGE$, as our $X$ variable. We calculate $WEDGE$ as insider voting rights minus insider cash-flow rights. For single-class firms, $WEDGE$ is zero by definition. The estimation techniques are analogous to those in the $DUAL$ regressions. These results show some pattern, with all five point estimates negative, four of which are significant at the ten-percent or five-percent levels.

As discussed in Section 4.1.5, the endogeneity of dual-class status can cloud inference in the single-stage regressions. We estimate two-stage regressions by combining all the regressors from (2) and (3) into a first-stage OLS estimate for dual-class status (or for $WEDGE$), and then substituting the fitted value into the right-hand side of (3). To be useful as instrumental variables, the variables excluded from the second-stage regression must be significantly correlated with the ownership variable ($DUAL$ or $WEDGE$) and be uncorrelated with the second-stage error term. For these full-
sample regressions, these data are not able to satisfy both of these conditions at the same time. The variables in Table 5 easily satisfy the first condition, but do not satisfy the second. While subsets of these variables can be selected to meet the second condition, these instruments are weak and do not meet the first condition. Overall, we are unable to control for endogeneity in the full sample, so we can only present the single-stage results. We will be able to do better in the dual-class and separation samples analyzed in the next two sections.

4.2.2 – Dual-Sample Results

While the full-sample results are a useful start, the real payoff of this data set is the ability to simultaneously estimate coefficients for different ownership variables. In the absence of a structural model, we should not rely on any one specification. Instead, we use several different reduced-form regressions to reflect a variety of plausible pathways from ownership structure to valuation. In our first set of regressions (Table 7), we use cash-flow rights ($CF$) and voting rights ($VOTE$) as the key independent variables. The idea behind these specifications is that $CF$ and $VOTE$ act differently on the incentives of insiders, and each type of ownership can exert an independent effect on valuation. This motivation was first suggested by Morck, Shleifer and Vishny (1988), and has been repeated in many of the papers that followed. To handle nonlinearities in these effects, many of these previous papers estimated piecewise regressions. To avoid having to choose specific piecewise thresholds, we just include squared terms in some of the specifications. We do not include the $WEDGE$ variable because it is a linear combination of $CF$ and $VOTE$. 
As in the full-sample case, we first discuss the single-stage results. The first five columns of Panel A provide estimates when only the levels of $CF$ and $VOTE$ are included. As in all tables in this section, we use five different specifications: column (1) gives median-estimation results with $Q'$ as the dependent variable, column (2) gives FM OLS results with $\ln Q'$ as the dependent variable and AR-corrected standard errors, column (3) gives pooled OLS results with Thompson-corrected standard errors, and columns (4) and (5) replicate columns (2) and (3) with $-1/Q'$ as the dependent variable. In each case, the coefficient on $CF$ is positive and the coefficient on $VOTE$ is negative. These coefficients are statistically significant in seven out of ten cases, with somewhat stronger results for the $VOTE$ coefficients.

Columns (6) through (10) estimate the same five specifications using a quadratic form, with $X$ containing $CF$, $CF^2$, $VOTE$, and $VOTE^2$. The pattern of results is similar in all specifications: positive coefficients on $CF$ and negative coefficients on $CF^2$ for the cash-flow variables, and the reverse pattern of negative coefficients on $VOTE$ and positive coefficients on $VOTE^2$ for the voting variables. Out of 20 total coefficients, 14 are significant at the ten-percent level, and seven are significant at the one-percent level.

With different signs on the level and squared terms, a diagram can help us to visualize the total effect for these variables. Figure 1 plots the total effect of $CF$ and $VOTE$ – with 95 percent confidence bands – based on the coefficients in Column 6 of Table 7. The total effect of the $CF$ variables peaks when cash-flow rights are about 60 percent, where this level is associated with 25 percentage points higher (median) $Q$. The total effect for the $VOTE$ variables falls for the entire range, reaching about $-32$ percent at $VOTE = 100$ percent. Figure 2 plots the net effect. Like Morck, Shleifer, and Vishny
(1988) and McConnell and Servaes (1990), we find that this relationship first increases and then decreases. In our sample, the net effect of insider ownership peaks at about 5 percentage points when ownership is approximately 30 percent.

As discussed above in Section 4.1, these single-stage results may suffer from sample-selection bias: even if the results are correct for all dual-class firms, it does not necessarily mean that we can extend the results to all firms. To make this extension, we adjust for sample selection using the technique of Heckman (1979), with a first-stage probit regression for $DUAL$ with all the elements of $Z$ from regression (2) and $W$ from regression (3) as regressors. This first-stage regression has an $R^2$ of 0.11, and a partial-$R^2$ (for the variables excluded from, the second-stage) of 0.07. These excluded variables are jointly significant at the one-percent level.\footnote{As discussed above in Section 4.2.1, these excluded variables fail the exogeneity test in the full sample. In the dual-class sample used here, we do not reject exogeneity. These tests will be discussed below in our analysis of the IV regressions.}

The Heckman procedure cannot be used when median regression is the second stage, nor can we compute Thompson-corrected standard errors, so we can only perform these tests for the OLS estimations of $\ln Q'$ and $-1/Q'$ with AR-corrected standard errors. Panel B of Table 7 gives the results. Columns (1) and (2) provide the results for the level regressions, and columns (3) and (4) provide the results for the quadratic regressions. For the level regressions, all the coefficients have the same signs as their analogues in Panel A, and with higher t-statistics in all cases. The quadratic regressions summarized in columns (3) and (4) of Panel B also yield nearly identical results as in Panel A. Overall, the sample-selection regressions are very similar to the single-stage regressions.
We next attempt to control for endogeneity by estimating IV regressions. As discussed above, IV estimations require two conditions: first, that the instruments be correlated with the endogenous regressors and, second, that these instruments be uncorrelated with the residual in the second-stage regression. In the first-stage regressions, we estimate pooled regressions of the endogenous variables \((CF, CF^2, VOTE, and VOTE^2)\) on all the exogenous variables from regressions (2) and (3). The results are summarized in Table 8. Only a subset of these variables will be excluded in the second-stage regressions. These variables are the “instruments” for the second stage, and are printed in bold in the table.

The key test statistics for these first-stage regressions are given at the bottom of the table. The p-value for the joint significance of the instruments is given just below the coefficients; in each regression, we can reject the joint null hypothesis at the one-percent level. With four endogenous regressors, it is possible to have low p-values in each regression but still not be identified, since it is possible that each endogenous variable is driven by the same small subset (< 4) instruments. To explore this possibility, we compute the partial R\(^2\) and Shea partial R\(^2\) for the instruments.\(^{20}\) Since Table 8 shows that these two measures have similar magnitudes in all four first-stage regressions, we conclude that we can separately identify all four endogenous variables. Thus, our IV estimation meets the first test: the instruments are significantly correlated with the (possibly) endogenous regressors.

\(^{20}\) The partial R\(^2\) gives the marginal R\(^2\) for the excluded instruments in each regression, and the “Shea” R\(^2\) is a type of partial R\(^2\) that accounts for the correlations among the instruments. While there is no formal test for identification of multiple instruments, Baum et al (2003) recommend “as a rule of thumb, if an estimated equation yields a large value of the standard partial R\(^2\) and small value of the Shea measure, one may conclude that the instruments lack sufficient relevance to explain all the endogenous regressors, and the model may be essentially unidentified.”
Next, we return to Table 7 for the results of the second-stage regressions. In Panel C, we summarize the results for each specification. The point estimates in Panel C are similar to their single-stage analogues in Panel A, but the standard errors are much larger. Nevertheless, the coefficient on the level term for cash flow is positive and significant in six of the ten IV specifications, with relatively stronger results in the quadratic specifications. The last row of Panel C gives the p-values for the overidentifying restrictions: the second condition for valid IV regression. In each case, we cannot reject the null hypothesis that the instruments, as a group, are exogenous to the second-stage residuals. We also repeated these exogeneity tests for subsets of the instruments, including the NAME variable, the subset of all of the MSA-level variables, and the subset of all dummy variables (for IPO year and industry). We do not reject exogeneity restrictions for any of these subsets.

Overall, the IV point estimates are similar in sign and magnitude to the OLS results, but the significance levels are lower. Furthermore, while our tests indicate that the regressions are identified and the instruments are valid, it is still possible to have bias due to “weak instruments.” Staiger and Stock (1997) analyze a setting with one endogeneous variable and suggest that a first-stage F-statistic less than ten is suggestive of a weak instruments problem. Stock and Yogo (2005) analyze models with multiple endogenous variables, and show that the potential for weak-instruments bias is essentially driven by the lowest first-stage F-statistic, with critical values that depend on the “acceptable” level of bias. In our case, the F-statistics are low enough to suggest a possible weak instruments problem. In that case, the IV estimates are biased towards the OLS estimates.
4.2.3 – Separation-Sample Results

When analyzing the entire dual-class universe, we are mixing several different ownership structures. This mixing can cloud inference, especially if the underlying relationship between value and ownership has complex nonlinearities that are not captured by our simple quadratic specification. Previous studies have attempted to handle these nonlinearities with piecewise regressions, but it is difficult to specify the “correct” piecewise segments \textit{a priori}, and concerns about data mining make us wary of conducting an empirical search. Instead, we attempt to adjust for the most obvious possibility of nonlinearity by analyzing firms in our separation sample. Recall that this sample includes all dual class firms where insiders have voting control \((VOTE > 0.50)\) but do not have a majority of the cash-flow rights \((CF < 0.50)\), and comprises about 40 percent of the dual-class universe. Since the marginal impact of additional voting rights above 50 percent does not affect insider control, we can obtain sharper results by focusing this analysis on the relationship between value and cash-flow rights.

Table 9 summarizes the results of estimating (3) on the separation sample. The panels and columns of Table 9 are analogous to those in Table 7, except that here the \(X\) vector omits the \textit{VOTE} variables and includes only the \textit{CF} variables. The results for the level regressions (columns (1) to (5) in all panels) are robust across all specifications, with the coefficients on \textit{CF} positive and significant in all cases. For the Heckman specifications (Panel B), the selection equation uses separation-sample status as the dependent variable, and provides nearly identical results to their single-stage analogues (Panel A).
For the IV regressions, the first-stage regression fits much better here than in previous cases. In untabulated results, we compute the F-statistics for the instruments in the first-stage regressions for both CF and CF². In both cases, we can reject easily at the one percent level. Furthermore, the partial R² for the instruments (not shown in the table) are 0.32 for CF and 0.36 for CF², and the corresponding values for the Shea partial R² are 0.31 in both cases. All of these measures are much higher than found for the full-sample or dual-sample results. Furthermore, the relevant F-statistics for these first-stage regressions are 7.8 and 8.5. While we do not have a formal test to rule out a weak-instruments problem, these F-statistics suggest that any bias would be relatively small.

The second-stage IV results are summarized in Panel C of Table 9. The point estimates are significant in three of the five cases for the level regressions. Table 9 also shows the p-values for the J-test on the overidentifying restrictions in the second-stage. In all cases, we fail to reject these restrictions, with p-values ranging from 0.263 to 0.301. Overall, the results in the separation sample provide the strongest evidence on the relationship between cash-flow rights and firm value.

5. Conclusions

In this paper, we construct and analyze a comprehensive sample of dual-class companies in the United States during the 1995 to 2002 period. We use these data to perform three sets of analyses. First, we show the prevalence of the dual-class structure and summarize the most salient characteristics of dual-class firms. We find that approximately six percent of all Compustat firms have more than one class of common stock, with this group comprising eight percent of the market capitalization of all the
firms. The typical dual-class firm has a superior (nontraded) class of shares with ten votes per share and an inferior (traded) class of shares with one vote per share, with insiders controlling about 60 percent of the voting rights and 40 percent of the cash-flow rights.

Second, we use the classification of all Compustat firms to analyze the determinants of dual-class status. We find several variables that predict dual-class status. The most powerful predictor is whether a person’s name appears in the company’s name at the time of the IPO. Other significant predictors – all measured at the time of IPO – are whether the firm is in a media industry, the number of firms in the same metropolitan area, the size of firms in the same metropolitan area, and the sales of the firm relative to others going public in the same year.

Our third set of analyses constitutes the main contribution of the paper. We use the separation of voting rights and cash-flow rights to disentangle the incentive and entrenchment effects in the relationship of insider ownership and firm value. In a series of single-stage regressions, we find that firm value is positively associated with insiders’ cash-flow rights and negatively associated with insiders’ voting rights, and negatively associated with the wedge between the two. One advantage of the dual-class sample is that we can use predictive variables from the determinants analysis to control for self-selection of dual-class status or endogeneity of ownership structure. Here, the results are less clear: the point estimates and magnitudes remain the same for almost all coefficients, but the significance levels are lower. The strongest results come from the separation sample – where insiders have voting control but less than 50 percent of the cash flow rights. For these firms, all the evidence supports the positive effect of cash flow on valuation.
An empirical relationship between firm value and ownership structure – even if it is causal – does not imply that any actor is behaving irrationally. A majority owner of a private company can rationally choose to sacrifice some firm value in order to maintain private benefits of control. The ability to control editorial policy at a newspaper, corporate strategy at a software company, or brand identity at a consumer company can all bring utility to individual manager-owners. Such utility can outweigh financial losses, particularly if the insiders are already very wealthy. The analysis of this paper allows us to estimate the average size of these losses in mature companies. With these measurements, we can begin to quantify the impact of this most extreme form of corporate governance.

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Smart, Scott, Ramabhadran S. and Chad Zutter, 2006, What’s in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values, working paper, Indiana University.


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Appendix A: Variable Definitions for Q Regressions

We define year \( t \) as beginning in December of calendar year \( t \) and ending in November of calendar year \( t+1 \). Then the additional variables for regressions in each month of year \( t \) are as follows:

- **Log assets**: The log of assets (Compustat item 6) measured in millions of dollars during fiscal year \( t \).
- **SP500**: An indicator variable for inclusion in the S&P 500 as of the end of calendar year \( t \).
- **Log age**: The log of age in months as of the end of calendar year \( t \).
- **Debt/Market Equity**: The ratio of debt (Compustat item 9) to the market value of equity, where debt is measured in fiscal year \( t-1 \), the market value of equity is measured at the end of calendar year \( t-1 \), and the market value of equity for dual-class firms with non-trading classes is calculated using shares outstanding from the year-\( t-1 \) proxy statements and assuming equal prices across classes.
- **Dividends/Book Equity**: The ratio of dividends (Compustat item 21) to book equity (Compustat item 60) in fiscal year \( t-1 \).
- **R&D/Sales**: The ratio of research and development (Compustat item 46) to sales (Compustat item 12) in fiscal year \( t-1 \). This variable is set equal to zero when R&D is missing.
- **Capex/PPE**: The ratio of capital expenditures (Compustat item 128) to gross property, plant, and equipment (Compustat item 7) in fiscal year \( t-1 \).
- **Advertising/Sales**: The ratio of advertising (Compustat item 45) to sales in fiscal year \( t-1 \). This variable is set equal to zero when advertising is missing.
- **Sales Growth**: One-year sales growth in fiscal year \( t-1 \).
- **Diversification**: An indicator variable that equals one when the firm has more than one Compustat business segment during fiscal year \( t \).
Table 1: Voting and Ownership Structure

Panel A of this table describes dividend and voting arrangements in the dual-class sample between 1995 and 2002. It summarizes the relationship between the superior class and the inferior class with the most votes per share of any inferior class. Panel B summarizes cashflow and voting ownership in the dual-class firms. *VOTE* is the total percentage of votes owned by officers and directors across classes, as reported in proxy statements. *CF* is the total percentage of cashflow ownership by officers and directors. Rights to the firm’s cashflows are assumed to be proportional to the ordinary dividends of that class if dividend data exists. If dividend data does not exist or if the dividend distribution is not ordinary, cashflow rights are assumed to be equal across classes. The separation sample refers to dual-class firms that have *VOTE* greater than 50 percent and *CF* less than 50 percent. Proportional directors refers to an arrangement in which different classes elect different directors.

<table>
<thead>
<tr>
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</tr>
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<tbody>
<tr>
<td>Number of single-class firms</td>
<td>6785</td>
<td>6996</td>
<td>7619</td>
<td>7609</td>
<td>7230</td>
<td>7015</td>
<td>6678</td>
</tr>
<tr>
<td>Number of dual-class firms</td>
<td>400</td>
<td>444</td>
<td>485</td>
<td>504</td>
<td>489</td>
<td>482</td>
<td>434</td>
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<tr>
<td>In separation sample</td>
<td>167</td>
<td>180</td>
<td>167</td>
<td>175</td>
<td>181</td>
<td>167</td>
<td>171</td>
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<tr>
<td>All classes trade publicly</td>
<td>77</td>
<td>76</td>
<td>72</td>
<td>74</td>
<td>77</td>
<td>68</td>
<td>64</td>
</tr>
<tr>
<td>Only inferior classes trade</td>
<td>281</td>
<td>312</td>
<td>346</td>
<td>360</td>
<td>344</td>
<td>352</td>
<td>322</td>
</tr>
</tbody>
</table>

Dual-class voting arrangements
- Voting ratio > 1:10
- Voting ratio = 1:10
- Voting ratio < 1:10
- With proportional directors

Dual-class dividend arrangements
- Superior < Inferior
- Superior = Inferior
- Superior > Inferior

Panel B: Ownership Structure

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Average <em>CF</em></td>
<td>39.8</td>
<td>39.7</td>
<td>39.8</td>
<td>39.3</td>
<td>39.7</td>
<td>40.0</td>
<td>40.2</td>
<td>37.6</td>
</tr>
<tr>
<td>In Superior Class</td>
<td>22.8</td>
<td>22.6</td>
<td>24.2</td>
<td>24.0</td>
<td>24.0</td>
<td>24.1</td>
<td>24.2</td>
<td>21.5</td>
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<tr>
<td>In Inferior Class(es)</td>
<td>17.0</td>
<td>17.1</td>
<td>15.6</td>
<td>15.3</td>
<td>15.7</td>
<td>15.9</td>
<td>16.0</td>
<td>16.1</td>
</tr>
<tr>
<td>Average <em>VOTE</em></td>
<td>61.7</td>
<td>61.1</td>
<td>60.9</td>
<td>60.4</td>
<td>61.0</td>
<td>61.5</td>
<td>62.9</td>
<td>61.8</td>
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<tr>
<td>In Superior Class</td>
<td>54.5</td>
<td>53.9</td>
<td>54.1</td>
<td>53.6</td>
<td>53.7</td>
<td>54.0</td>
<td>55.6</td>
<td>54.5</td>
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<tr>
<td>In Inferior Class(es)</td>
<td>7.2</td>
<td>7.2</td>
<td>6.8</td>
<td>6.8</td>
<td>7.4</td>
<td>7.5</td>
<td>7.3</td>
<td>7.3</td>
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</table>
Table 2: Relationship Between Managerial Voting Ownership and Cash Flow Ownership

This table summarizes cashflow and voting ownership in the dual-class firms between 1995 and 2002. As defined in Table 1, \( VOTE \) and \( CF \) are the total percentages of votes and cashflow, respectively, owned by officers and directors across classes as reported in proxy statements.

<table>
<thead>
<tr>
<th>Cashflow (( CF ))</th>
<th>0-5</th>
<th>5 - 10</th>
<th>10 - 15</th>
<th>15-20</th>
<th>20-25</th>
<th>25-30</th>
<th>30-35</th>
<th>35-40</th>
<th>40-45</th>
<th>45-50</th>
<th>50-55</th>
<th>55-60</th>
<th>60-65</th>
<th>65-70</th>
<th>70-75</th>
<th>75-80</th>
<th>80-85</th>
<th>85-90</th>
<th>90-95</th>
<th>&gt;95</th>
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<td>0-5</td>
<td>69</td>
<td>10</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<td>0</td>
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<td>0</td>
<td>0</td>
<td>0</td>
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<td>0</td>
<td></td>
</tr>
<tr>
<td>5 - 10</td>
<td>10</td>
<td>38</td>
<td>5</td>
<td>6</td>
<td>2</td>
<td>0</td>
<td>1</td>
<td>0</td>
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Table 3: Summary Statistics

This table gives means and medians (in brackets beneath the mean) of several variables for dual- and single-class firms in 2000. The single-class sample consists of all firms in the CRSP-Compustat merged database, excluding the firms identified as dual-class. Assets is the book value of assets in millions of dollars (Compustat item 6); Debt/Assets is the ratio of long-term debt (item 9) to assets; SP500 is a dummy variable for inclusion in the S&P 500 as of the end of calendar year 2000; Age is firm age in years as of December 2000; Market Cap is market value in millions at the end of 2000, where the market value for dual-class firms with non-trading classes is calculated using shares outstanding from proxy statements and assuming equal prices across classes; and BM is the ratio of book value [the sum of book common equity (item 60) and deferred taxes (item 74)] to size at the end of 2000. Significant differences for the means are indicated at the ten-, five-, and one-percent levels by *, **, and ***, respectively. The Wilcoxon rank-sum test p-values for the medians are given in brackets in the third column.

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Table 4: Four-Factor Return Regressions

This table presents the results of four-factor regressions of equal- and value-weighted monthly returns for portfolios of firms in the dual-class sample or the separation sample. The separation sample refers to dual-class firms that have $VOTE$ greater than 50 percent and $CF$ less than 50 percent. The explanatory variables are $RMRF$, $SMB$, $HML$, and $UMD$. These variables, which were downloaded from Kenneth French’s website, are the returns to zero-investment portfolios designed to capture market, size, book-to-market, and momentum effects, respectively. The sample period is from July 1995 through June 2003. Standard errors are presented in parentheses, and significance at the ten-, five- and one-percent levels is indicated by *, **, and ***, respectively.

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<td>(0.231)</td>
<td>(0.059)</td>
<td>(0.056)</td>
<td>(0.074)</td>
<td>(0.038)</td>
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<td>0.878***</td>
<td>0.646***</td>
<td>0.250***</td>
<td>-0.272***</td>
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<td>(0.055)</td>
<td>(0.052)</td>
<td>(0.069)</td>
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Table 5: Selection Equation

This table reports the results of annual probit regressions from December of each year, where the dependent variable is an indicator variable equal to one when the firm is in the dual-class sample and zero otherwise. The entire sample of single- and dual-class firms is used. The last column shows the results from a single regression that includes each firm during the first year it appears in the sample and again for each change in dual-class status. Name is a dummy variable for firms with family names at the time of CRSP listing. Its construction is discussed in the text. Media is a dummy variable for firms in media industries at the time of CRSP listing. Media industries are defined as SIC codes 2710-11, 2720-21, 2730-31, 4830, 4832-4833, 4840-41, 7810, 7812, and 7820. StateLaw is an index of state takeover laws defined in Gompers, Ishii, and Metrick (2003) from the firm’s state of incorporation in the previous year. SalesRank is the firm’s percentile of sales in its first year appearing in Compustat in the distribution of all other firms new to Compustat. ProfitRank is the analogous percentile for income before extraordinary items available for common. %Firms is the percentage of firms located in this firm’s region in the year prior to its first appearance in Compustat relative to all firms in Compustat during that year. Region is defined as a metropolitan or micropolitan statistical area or a metropolitan division when one exists, and a county otherwise. %Sales is the analogous figure for revenue. Sales/RegionSales is sales divided by total sales in this firm’s region in its first year appearing in Compustat. Dummy variables for CRSP listing year and the 48 industries designated by Fama and French (1997) are also included in the regressions, but these coefficients are omitted from the table. In this set of regressions and in all regressions in the following tables, we drop firms in utilities or financial industries by omitting firms in the Utilities, Banking, Insurance, and Trading industries as designated by Fama and French (1997). Significance at the ten-, five- and one-percent levels is indicated by *, **, and *** , respectively.

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</table>
Table 6: Full Sample Valuation Regressions

This table presents results from valuation regressions using the entire sample of dual- and single-class firms. The dependent variable is either Tobin’s $Q$, $\ln(Q)$, or $-1/Q$. $Q$ is the ratio of the market value of assets to the book value of assets: the market value is calculated as the sum of the book value of assets and the market value of common stock less the book value of common stock and deferred taxes. The market value of equity for dual-class firms with non-trading classes is calculated using shares outstanding from proxy statements and assuming equal prices across classes. The market value of equity is measured at the end of the current calendar month, and the accounting variables are measured in the current fiscal year for December and the previous fiscal year for January through November. The primary explanatory variables are $DUAL$, an indicator for dual-class status, and $WEDGE$, which equals the difference between voting and cashflow ownership by officers and directors ($VOTE-CF$). Regressions using Thompson standard errors are pooled regressions with standard errors below in parentheses based on Thompson (2006). In the other columns, a separate regression is estimated for each of the 96 months from December 1995 through November 2003. For each explanatory variable, we present the time-series average of the monthly coefficients with the standard error below in parentheses. The calculation of these standard errors corrected for time-series correlation is described in Section 4.1.3. Significance at the ten-, five- and one-percent levels is indicated by *, **, and ***, respectively.

As additional explanatory variables, we include the log of assets; an indicator for inclusion in the S&P 500; the log of age; the ratio of debt to the market value of equity; the ratio of dividends to book equity; the ratio of research and development to sales; the ratio of capital expenditures to property, plant, and equipment; the ratio of advertising to sales; sales growth; a diversification dummy; and a media industry dummy. See Appendix A for details on the construction of these variables. Their coefficients are omitted from the table for brevity, but full results are available on request.

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<td>$\ln(Q)$</td>
<td>$\ln(Q)$</td>
<td>$-1/Q$</td>
<td>$-1/Q$</td>
<td>$Q$</td>
<td>$\ln(Q)$</td>
<td>$\ln(Q)$</td>
<td>$-1/Q$</td>
<td>$-1/Q$</td>
</tr>
<tr>
<td>$DUAL$</td>
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<td>-0.019</td>
<td>-0.023</td>
<td>-0.017</td>
<td>-0.018</td>
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</tr>
<tr>
<td></td>
<td>(0.026)</td>
<td>(0.024)</td>
<td>(0.024)</td>
<td>(0.015)</td>
<td>(0.016)</td>
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<tr>
<td>$WEDGE$</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>-0.224**</td>
<td>-0.140</td>
<td>-0.145**</td>
<td>-0.114*</td>
<td>-0.116**</td>
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<td>(0.066)</td>
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<td>(0.072)</td>
<td>(0.067)</td>
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<td>Thompson std error</td>
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<td>No</td>
<td>Yes</td>
<td>No</td>
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<td>No</td>
<td>No</td>
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Table 7: Dual Sample Valuation Regressions: Cash Flow and Voting

This table presents results from valuation regressions using the sample of dual-class firms. The dependent variable is either Tobin’s $Q$, $\ln(Q)$, or $(-1/Q)$, where $Q$ is as defined in Table 6. The primary explanatory variables are $CF$, $CF^2$, $VOTE$, and $VOTE^2$. $CF$ and $VOTE$ are cashflow and voting ownership by officers and directors, as defined in Table 1. Regressions using Thompson standard errors are pooled regressions with standard errors below in parentheses based on Thompson (2006). In other columns, a separate regression is estimated for each of the 96 months from December 1995 through November 2003. For each explanatory variable, we present the time-series average of the monthly coefficients with the standard error below in parentheses. The calculation of these standard errors corrected for time-series correlation is described in Section 4.1.3.

As additional explanatory variables, we include the log of assets; an indicator for inclusion in the S&P 500; the log of age; the ratio of debt to the market value of equity; the ratio of dividends to book equity; the ratio of research and development to sales; the ratio of capital expenditures to property, plant, and equipment; the ratio of advertising to sales; sales growth; a diversification dummy; and a media industry dummy. See Appendix A for details on the construction of these variables. Their coefficients are omitted from the table for brevity, but full results are available on request.

The Heckman specifications in Panel B use the two-step Heckman procedure, where for each monthly regression, a first-stage probit regression is estimated as in Table 5. In the IV specifications in panel C, we instrument for $CF$, $CF^2$, $VOTE$, and $VOTE^2$ using the other explanatory variables as well as the variables from the selection equation. In the IV-Median specifications, the same instruments are used in a procedure analogous to two-stage-least-squares in which the second stage is a median regression. Significance at the ten-, five- and one-percent levels is indicated by *, **, and ***, respectively.

<table>
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<td>OLS</td>
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<td>$\ln(Q)$</td>
<td>$\ln(Q)$</td>
<td>$-1/Q$</td>
<td>$-1/Q$</td>
<td>$Q$</td>
<td>$\ln(Q)$</td>
<td>$\ln(Q)$</td>
<td>$-1/Q$</td>
<td>$-1/Q$</td>
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<tr>
<td>$CF$</td>
<td>0.256***</td>
<td>0.231</td>
<td>0.217</td>
<td>0.188*</td>
<td>0.177*</td>
<td>0.815***</td>
<td>0.718**</td>
<td>0.613</td>
<td>0.549***</td>
<td>0.488*</td>
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<td></td>
<td>(0.073)</td>
<td>(0.204)</td>
<td>(0.133)</td>
<td>(0.100)</td>
<td>(0.093)</td>
<td>(0.115)</td>
<td>(0.343)</td>
<td>(0.414)</td>
<td>(0.230)</td>
<td>(0.280)</td>
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<tr>
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<td>-0.573*</td>
<td>-0.461</td>
<td>-0.423**</td>
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<td>(0.291)</td>
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<td>-0.247**</td>
<td>-0.186**</td>
<td>-0.188**</td>
<td>-0.471***</td>
<td>-0.647***</td>
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<td>(0.075)</td>
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<td>0.251***</td>
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<td>0.181 (0.109)</td>
<td>0.862** (0.347)</td>
<td>0.629*** (0.230)</td>
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Panel C

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- 

| J test p-value | 0.401 | 0.201 | 0.310 | 0.165 |
| Thompson std error | No | No | Yes | No | Yes | No | No | Yes | Yes |
Table 8: First-Stage Regressions

This table shows the results of the pooled first-stage regressions using the entire sample of dual-class firms. The dependent variable is $CF$, $CF^2$, $VOTE$, or $VOTE^2$. $CF$ and $VOTE$ are cashflow and voting ownership by officers and directors, as defined in Table 1. Table 5 and Appendix A provide details on the construction of the explanatory variables. Dummy variables for CRSP listing year and the 48 industries designated by Fama and French (1997) are also included in the regressions, but these coefficients are omitted from the table. Standard errors clustered by firm are presented below in parentheses. Significance at the ten-, five- and one-percent levels is indicated by *, **, and ***, respectively. There are 23775 observations in each regression. The final four rows of the table show the test statistic and p-value from an F-test on the excluded instruments and the partial R$^2$ and Shea partial R$^2$ of the excluded instruments.

<table>
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<tr>
<th>Name</th>
<th>$CF$</th>
<th>$CF^2$</th>
<th>$VOTE$</th>
<th>$VOTE^2$</th>
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<td><strong>StateLaw</strong></td>
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<td>(0.0006)</td>
<td>(0.0005)</td>
<td>(0.0007)</td>
<td>(0.0008)</td>
</tr>
<tr>
<td><strong>ProfitRank</strong></td>
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<td>-0.0003</td>
<td>-0.0006</td>
<td>-0.0007</td>
</tr>
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<td>(0.0004)</td>
<td>(0.0004)</td>
<td>(0.0005)</td>
<td>(0.0006)</td>
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<td><strong>%Firms</strong></td>
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<td>(0.0130)</td>
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<tr>
<td><strong>%Sales</strong></td>
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<td>0.0014</td>
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<td>(0.0052)</td>
<td>(0.0070)</td>
<td>(0.0080)</td>
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<td><strong>Sales/RegionSales</strong></td>
<td>-0.0142</td>
<td>-0.0384</td>
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<td><strong>SP500</strong></td>
<td>-0.1623***</td>
<td>-0.1315***</td>
<td>-0.1048*</td>
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<td>(0.0417)</td>
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<td>(0.0615)</td>
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<td><strong>LogAge</strong></td>
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<td>-0.0349*</td>
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<td><strong>Debt/MarketEquity</strong></td>
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<td>(0.0040)</td>
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<td><strong>Dividends/BookEquity</strong></td>
<td>0.0315*</td>
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<td><strong>R&amp;D/Sales</strong></td>
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<td>-0.0026</td>
<td>-0.0025</td>
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<tr>
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<td>(0.0011)</td>
<td>(0.0007)</td>
<td>(0.0021)</td>
<td>(0.0016)</td>
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<td><strong>Capex/PPE</strong></td>
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<td>0.0115</td>
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<td>(0.0381)</td>
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<td>(0.0354)</td>
<td>(0.0446)</td>
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<td><strong>Advertising/Sales</strong></td>
<td>0.2899</td>
<td>0.3076*</td>
<td>0.2716</td>
<td>0.4030*</td>
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<tr>
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<td>(0.1866)</td>
<td>(0.1762)</td>
<td>(0.1873)</td>
<td>(0.2199)</td>
</tr>
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<td>-0.0267</td>
<td>-0.0353*</td>
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<td>(0.0134)</td>
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<td>-0.0121</td>
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<td>(0.0150)</td>
<td>(0.0133)</td>
<td>(0.0180)</td>
<td>(0.0217)</td>
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<td><strong>Media</strong></td>
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<td>-0.0072</td>
<td>0.1091**</td>
<td>0.1202*</td>
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<td>(0.0451)</td>
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<td>(0.0538)</td>
<td>(0.0631)</td>
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| F statistic | 6.57 | 4.44 | 3.71 | 3.09 |
| F test p-value | 0.0000 | 0.0000 | 0.0000 | 0.0000 |
| Partial R$^2$ | 0.1968 | 0.1712 | 0.2042 | 0.1768 |
| Shea Partial R$^2$ | 0.1864 | 0.1648 | 0.1688 | 0.1448 |
Table 9: Separation Sample Valuation Regressions

This table presents results from monthly valuation regressions using the sample of dual-class firms that have \textit{VOTE} greater than 50 percent and \textit{CF} less than 50 percent. The dependent variable is either Tobin’s \(Q\), \(\ln(Q)\), or \(-1/Q\), where \(Q\) is as defined in Table 6. The primary explanatory variables are \(CF\) and \(CF^2\). \(CF\) is cashflow ownership by officers and directors, as defined in Table 1. Regressions using Thompson standard errors are pooled regressions with standard errors below in parentheses based on Thompson (2006). In other columns, a separate regression is estimated for each of the 96 months from December 1995 through November 2003. For each explanatory variable, we present the time-series average of the monthly coefficients with the standard error below in parentheses. The calculation of these standard errors corrected for time-series correlation is described in Section 4.1.3.

As additional explanatory variables, we include the log of assets; an indicator for inclusion in the S&P 500; the log of age; the ratio of debt to the market value of equity; the ratio of dividends to book equity; the ratio of research and development to sales; the ratio of capital expenditures to property, plant, and equipment; the ratio of advertising to sales; sales growth; a diversification dummy; and a media industry dummy. See Appendix A for details on the construction of these variables. Their coefficients are omitted from the table for brevity, but full results are available on request.

The Heckman specifications in panel B use the two-step Heckman procedure where for each monthly regression, a first-stage probit regression is estimated where the dependent variable is a dummy variable equal to one when the firm is in the separation sample and the explanatory variables described in Table 5 are used. In the IV specifications in panel C, we instrument for \(CF\) and \(CF^2\), using the other explanatory variables as well as the explanatory variables from the selection equation described in Table 5. In the IV-Median specifications, the same instruments are used in a procedure analogous to two-stage-least-squares in which the second stage is a median regression. Significance at the ten-, five- and one-percent levels is indicated by *, **, and ***, respectively.

<table>
<thead>
<tr>
<th>Panel A</th>
<th>(1)</th>
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<td>(CF)</td>
<td>0.633***</td>
<td>0.701**</td>
<td>0.717***</td>
<td>0.513***</td>
<td>0.529***</td>
<td>1.220**</td>
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<td>(0.106)</td>
<td>(0.276)</td>
<td>(0.238)</td>
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<td>(0.175)</td>
<td>(0.521)</td>
<td>(0.674)</td>
<td>(0.974)</td>
<td>(0.412)</td>
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<td>(CF^2)</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td>(0.935)</td>
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Table 9, continued

Panel B

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Panel C

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<tr>
<td>$CF$</td>
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<td>0.554*</td>
<td>0.489</td>
<td>0.417***</td>
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<td>(0.410)</td>
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<td>$CF^2$</td>
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<td>(1.346)</td>
<td>(3.177)</td>
<td>(0.741)</td>
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J test p-value

|               | 0.301 | 0.263 | 0.286 | 0.290 |

Thompson std error

|               | No | No | Yes | No | Yes | No | Yes | No | Yes |


Figure 1
This figure plots the estimated relationship between Tobin’s $Q$ and the ownership variables, $CF$ and $VOTE$, with their 95 percent confidence bands. It uses the parameters in the sixth column of Panel A in Table 7 and holds the control variables fixed at zero. To compute the confidence bands, we assume that the regression coefficients follow AR(1) processes as described in Appendix B, and we allow for covariance between the contemporaneous random elements of these processes.
Figure 2
This figure plots the estimated relationship between Tobin’s $Q$ and ownership when $CF$ equals $VOTE$. It uses the parameters in the sixth column of Panel A in Table 7 and holds the control variables fixed at zero.
The Snap Inc. initial public offering was the first-ever to offer investors solely non-voting stock. Snap’s multi-class, non-voting capitalization gives Evan Spiegel and Robert Murphy, the company’s founders, and holders of ten-vote shares, a perpetual lock on control, without the need to hold an expensive ownership position. They exercise a decisive 89% of the voting power, despite holding only about 44% of the company’s total equity.

Dual- and multi-class capitalizations—in which founders and other insiders retain a class of high-vote shares while selling low-vote shares to the public—are nothing new for controlled companies. This mechanism has long allowed founding individuals and families to leverage minority economic ownership positions—say 10 or 20%—into total voting control of large companies such as Snap, Facebook, and Google. But the Snap plan stretches this logic to its limit—with no-vote shares, founders can sell off all but one voting share, and nonetheless control every aspect of company policy.

While the structure is recognized as problematic for ordinary investors, its effect on how the courts should treat director decision-making in these companies has not been
explored. Ultimately, no-vote stock requires courts to abandon the director-protective business judgment rule for these entities. That would lead to the demise of the multi-class, non-voting stock structure.

I. THE DUAL-CLASS AND NO-VOTE TRENDS

Not long ago, even simple dual-class capital structures were the anachronistic refuge of either media conglomerates or old-style industrial titans. The structure was used when the requirements for journalistic integrity and independence from the market demanded a safe-harbor fortified by an impregnable curtain of voting control—the New York Times Company, News Corp., and the Washington Post are the representative adopters. It was also used when a company had been built by a founder through such singular achievement that the market could be strong-armed into accepting little-to-no protection in exchange for the capital it was giving, in trust, to a “genius.” The Ford Motor Company, Berkshire Hathaway and Estée Lauder Companies are some well-known examples.

A twenty-first century trend, begun by Google in its 2004 I.P.O., is driving the dual-class capital structure out of the uncommon and into the mainstream. Increasingly, founders are opting to shore up control through highly leveraged voting structures, whereas only a decade ago almost all chose the standard and accepted one-share, one-vote structure for fear of a stock-market revolt and a public relations maelstrom. More than one-in-nine of the new companies being added to the Russell 300 index ranks through I.P.O.s is dual-class. In 2015, 13.5 percent of the 133 I.P.O.s listed dual-class shares, compared to just 1 percent in 2005.
As dual-class listings have proliferated, many companies have taken Google’s example and pushed the envelope even further. Zynga, which went public in 2011, raising over $1 billion, had a founder-only class of stock with a staggering seventy votes per share.

Now Snap has acknowledged that in companies with ten-to-one (or more) voting structures, public voting power is only a fiction. Its issuance of shares with no vote was unprecedented: instead of having no effective voting power, its new shares have no actual voting power. The no-vote structure will allow its co-founders Spiegel and Murphy, twenty-six and twenty-eight years old, respectively, to control the company until the day both are dead. Its board, totally controlled by them, instills little confidence amongst the non-voting shareholders. In this circumstance, why even have a board? Of course, the law and its desire to protect other investors—however limited its ability is—suggests otherwise.

With zero-vote I.P.O. stock, the logic of leveraging control from a minority interest through the dual-class structure has now reached its illogical conclusion. With nonvoting shares, a founder can now advise investors plainly, without any pretense or suggestion otherwise, that he or she will take their money but not their advice. The zenith has been reached, and in its wake is the normalization of the disenfranchisement of public shareholders through dual- and multi-class structures. Today 9% of the S&P 100—representing a staggering $2.26 trillion in market capitalization—is dual-class. In the Russell 3000, such companies represent 8.2% of the index. Now, the phenomenon extends well beyond the technology and media industries. Significant dual-class companies include AMC, Box, Nike, Ralph Lauren, Tyson Foods and Under Armor. Dual-class controlled
companies are steadily increasing in prominence, so hard thinking about the importance of the shareholder vote is due.

II. RECONSIDERATION OF STANDARD OF JUDICIAL REVIEW CALLED FOR

The growing number of dual-class companies in the American economy raises serious questions about how the courts will view transactions involving these companies in light of the accountability that a meaningful shareholder vote provides. While contemporary criticism of dual-class capitalizations has focused on the resulting reduction in accountability, the effect of this lessened accountability on the approach courts must take in reviewing the actions of these companies and their boards has not yet been considered. But this unexamined issue presents the most significant problem with permitting the use of dual-class structures. The long-settled policy of judicial restraint, wherein courts have concluded that with regards to business judgment management action will not be reviewed at all, must be reconsidered. American courts may decide that more active judicial intervention is necessary, and take on a greater responsibility for shareholder protection at these companies.

A. The traditional approach was highly deferential

The business judgment rule operates to bar a court from second-guessing the business judgment of an effectively functioning board of directors. In most circumstances, when a board of directors has acted in “good faith” and “with reasonable care” its decision will be considered a business judgment and not be interfered with by a reviewing court. This rule expresses the judicial reticence to second-guess the complex, real-time decisions
of management. Where applied, it is justified by the view that judicial intervention will not serve as a measure of additional shareholder protection. Areas in which the rule urges judicial restraint are therefore those where the board and market forces more cheaply and effectively accomplish protect the shareholder interest. But the presumption that extrajudicial regulation will stand in for courts to serve this goal is barely justified at the dual-class controlled companies which are now growing in prominence. At companies with nonvoting stock, it is not justified at all because controllers need not even have the powerful incentive which comes from significant ownership. Courts will need to confront this challenge to traditional business law doctrine.

Specifically, court intervention in the decision making process at ordinary dispersed-ownership public companies is duplicative and unproductive because shareholders are protected from poor managerial operating decisions by the markets in which those firms operate. At widely-held companies, management discretion is channeled towards the shareholder interest by the managerial labor, capital and corporate control markets. Together, these markets obviate the need for expensive litigation and judicial intervention. First, the managerial labor market—where skill is measured by the return management produces for shareholders—creates a strong incentive for management to run the firm efficiently. Insofar as a manager is concerned about her value in the labor market, her self-interest stands in for the courts to prevent her taking actions harmful to shareholders. If the labor markets do not do enough to induce efficient management, the capital and corporate control markets provide a failsafe. Poor performance will be reflected in depressed stock prices, which create an opportunity for the shares to be
acquired by someone who will fire the existing management and install more effective managers.

B. **Deferece is not justified with no vote or ownership**

Founders at dual-class companies are not subject to the same market constraints as managers at widely-held companies. This means inefficient operations can be sustained, at the expense of the public shareholders who hold the majority of the firm’s economic interest. This is because when founders go public with a controlled dual-class structure, they secure lifetime tenure. By possessing the controlling vote, they are unshackled from the market constraints. First, they need not fear the labor market consequences of inept, careless, or self-interested management because they are their own and only boss. Additionally, if they have sold off much of their equity interest, bad management will hurt them less economically. The (for-now-hypothetical) one-share owning, non-voting, dual-class controller will not hurt at all. Finally, open market speculators wishing for a change in management cannot demand to purchase the company from them — a controller can only lose control when and if they choose to.

Faced with these relaxed constraints, courts will want to abandon the protective business judgment rule and engage in meaningful review of operational decisions at dual-class companies, because nobody else can do it. But they will be have to face their inability to provide that protection effectively.
C. Heightened review is not feasible

If courts must take up heightened review of dual-class companies, the shareholders of those companies will have externalized the cost of monitoring their investment to the judicial system. This alone presents an important, and not at all previously discussed, reason for eliminating dual-class structures. We must now add the costs placed on society by engaging the judicial system in a difficult and expensive review endeavor to the numerous other arguments against the structure. This may be the most potent of those arguments, and calls for significant attention.

Unfortunately, if dual-class structures are allowed, courts will likely be forced, for practical reasons, to adopt this highly problematic posture. They will recognize a critical need for oversight, but, at the same time, need to abstain from intervening. But in choosing not to provide meaningful heightened review, there will still be costs imposed on the courts. The position will be in serious contradiction—not just tension—with the doctrinal framework governing review of corporations. Courts, today, treat the protection of shareholder interests as their primary task and objective. If they choose to allow dual-class companies to remain unaccountable, their credibility and reputation will be negatively affected.

This problem arises because courts are, for historic and practical reasons, reluctant and compositionally ill-suited to substitute their business judgment for that of experienced corporate management. For how is a judge any better at deciding business policy and direction than management or the board? The courts realize this shortcoming, which explains their reluctance to enter the fray. Thus, while heightened review might be
doctrinally prudent, it is practically unfeasible. In consequence, the entire concept of dual-class and nonvoting stock must ultimately be discarded.
Snap’s Not Looking to Chat With Shareholders

How the parent of mobile-messaging app SnapChat’s new stock structure will undermine investors, corporate governance and the courts.

By Charles M. Elson and Craig K. Ferrere

Increasingly, company founders have been opting to shore up control by creating stock ownership structures that undercut shareholder voting power — where only a decade ago almost all chose the standard and accepted one-share, one-vote model.

Now the Snap Inc. initial public offering (IPO) takes it even further with the public offering (IPO) takes extra votes to shore up control founders have been opting to do. The new structure: Why does Snap even need a board?

But the Snap plan stretches this logic to its limit — with no-vote shares, founders can sell off all but one voting share and nonetheless control every aspect of company policy. With zero-vote IPO stock, the logic of leveraging control from a minority interest through the dual-class structure has now reached its illogical conclusion. With non-voting shares, a founder can now advise investors plainly, without any pretense or suggestion otherwise, that he or she will take their money but not their advice.

The dual-class zenith has been reached, and in its wake is the normalization of the disenfranchisement of public shareholders through dual- and multi-class structures.

Today 9% of the S&P 100 — representing a staggering $2.26 trillion in market capitalization — is dual-class. In the Russell 3000, such companies represent 8.2% of the index. The phenomenon extends well beyond the market demanded a safe-harbor fortified by an impregnable curtain of voting control — the New York Times Company, News Corp., and The Washington Post are the representatives.

It was also used when a company had been built by a founder through such singular achievement that the market could be strong-armed into accepting little-to-no protection in exchange for the capital it was giving, in trust, to a “genius.” The Ford Motor Company, Berkshire Hathaway and The Estée Lauder Companies are some well-known examples.

A 21st-century trend, begun by Google in its 2004 IPO, is driving the dual-class capital structure out of the uncommon and into the mainstream. Increasingly, founders are opting to bolster control through highly leveraged voting structures, compared to the standard and accepted one-share, one-vote structure that was a constant for fear of a control takers to vote for directors and maintain accountability; directors are in the end just products of the company managers; managers who have already admitted to fumbling.

Control until death?

Snap’s multi-class, non-voting capitalization gives Spiegel and Robert Murphy, the company’s founders and holders of 10-vote shares, a perpetual lock on control, without the need to hold an expensive ownership position. They exercise a decisive 89% of the voting power, despite holding only about 44% of the company’s total equity.

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Snap’s issuance of shares with no vote was unprecedented: instead of having no effective voting power, its new shares have no actual voting power. The no-vote structure will allow its co-founders Spiegel and Murphy, 26 and 28 years old respectively, to control the company until the day both are dead.

Its board, totally controlled by them, instills little confidence amongst the non-voting shareholders. In this circumstance, why even have a board? Of course, the law and its desire to protect other investors, however limited its ability is, suggests otherwise.

Some in the investment community are pushing back. Index provider MSCI announced in early November it was temporarily leaving Snap out of its indexes because of what it deems an unfair shareholder voting structure, joining a growing chorus of skeptics who see such models as an insider boon.

“MSCI will temporarily treat any securities of companies exhibiting unequal voting structures as ineligible for addition to the MSCI ACWI Investable Market Index and MSCI US Investable Market 2500 Index,” the company said in a statement.

The growing number of dual-class companies in the American economy also raises serious questions about how the courts will view transactions involving these companies in light of the accountability that a meaningful shareholder vote provides.

Judicial quandary
While contemporary criticism of dual-class capitalizations has focused on the resulting reduction in accountability, the effect of this lessened accountability on the approach courts must take in reviewing the actions of these companies and their boards has not yet been considered. But this unexamined issue presents the most significant problem with permitting the use of dual-class structures.

The long-settled policy of judicial restraint, wherein courts have concluded that with regards to business judgment, management action will not be reviewed at all, must be reconsidered. American courts may decide that more active judicial intervention is necessary — because without a vote shareholders can’t provide oversight of the boards and thus management — and take on a greater responsibility for shareholder protection at these companies.

In most circumstances, when a board of directors has acted in “good faith” and “with reasonable care” its decision will be considered a business judgment and not be interfered with by a reviewing court. This rule expresses the judicial reticence to second-guess the complex, real-time decisions of management.

Courts will need to confront this challenge to traditional business law doctrine.

Without the board and market forces to protect shareholder interests, the burden of monitoring investments and dealing with problems will end up in the courts. If courts must take up heightened review of dual-class companies, that means adding to the costs placed on society by engaging the judicial system.

This alone presents an important, and not previously discussed, reason for eliminating dual-class structures.

If not, we may end up with a governance snap-judgment day.

Charles Elson is the Edgar S. Woolard Jr. Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Governance, University of Delaware. He can be contacted at elson@udel.edu.

Craig K. Ferrere served as the Edgar S. Woolard Jr. Fellow in Corporate Governance at the Weinberg Center from 2010-2014.