



## The Effects of Dual-class Ownership on Ordinary Shareholders

Published : June 30, 2004 in [Knowledge@Wharton](http://knowledge.wharton.upenn.edu/article.cfm?articleid=1001)

When Google announced in April that it would go public this year, some investors' eyebrows rose over the plan to issue a class of super shares to ensure that the founders keep control.

Each of the Class B shares reserved for insiders will carry 10 votes, while the ordinary Class A shares sold to the public will have just one vote each – a common ratio among the approximately 600 dual-class companies. The largest such companies are Berkshire Hathaway Inc., Viacom Inc., Comcast Corp., Cox Communications Inc. and Columbia Hospital Corp. Super shares are designed to give specific shareholders voting control, and in most cases these shares are not publicly traded. Shareholders-rights groups have long complained that dual-share systems violate the key one-share, one-vote principle.



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Do these arrangements really undermine the interests of people who own ordinary single-vote shares? Or do they help stabilize companies by insulating against takeover attempts and other disruptive events, as their proponents claim? The answers have important implications for the vast majority of companies that issue just one class of stock, because they shed light on another, broader question: Do ordinary shareholders benefit when a company's executives, directors and founders own large blocks of shares?

It depends on the nature of the ownership, says Wharton finance professor [Andrew Metrick](#). "Voting ownership is bad, economic ownership is good," he said, summarizing the results of a study that compared hundreds of dual-class companies with the larger universe of single-class companies from 1994 through 2001. "What you'd really like to do is give managers a lot of economic ownership in a company, but no votes, which is the opposite of what you see in most dual-class companies." Metrick conducted the study with Paul A. Gompers, professor of business administration at Harvard Business School, and Harvard economist Joy Ishii. Their paper is entitled, *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies*.

### Ownership Stakes vs. Voting Control

Wall Streeters, corporate leaders and many academics have long believed that executives and other insiders who own large blocks of their companies' shares work harder to boost share prices, benefiting all shareholders. At the same time, insiders with large blocks of votes can become entrenched – using voting clout to stave off outside shareholders' efforts to replace them if they perform poorly.

With single-class companies, where the insiders' economic stakes and voting clout are directly linked, it is very difficult to determine which force is more powerful, or how different levels of insider ownership affect corporate results. But at dual-class companies, ownership stake and voting control are not necessarily in the same hands. An executive might have a large ownership stake composed of ordinary single-vote shares, but at the same time possess little voting clout because the multi-vote shares are in the

hands of others. Or he could have many super shares and few ordinary ones, enjoying lots of control but having a small financial stake. Studying various combinations of ownership and control should reveal how each affects corporate results.

The study found that large ownership stakes in insiders' hands do tend to improve corporate performance, while heavy control by insiders weakens it. The authors looked at each company's value, measured by Tobin's Q, calculated by dividing the market value of its assets by the assets' replacement value. (Essentially, this is stock returns with some adjustments.) The higher the number, the better.

Company values improved as insider ownership rose, with the effect reaching a peak when insider ownership reached 33%, based on their share of "cash flow" such as dividends. As insider ownership grew from zero to 33%, Tobin's Q grew by about 15%. "As the fraction of cash flow ownership increases, the incentives of management become more closely aligned with those of outside shareholders and thus lead to better decisions (from outside shareholders' perspective) and higher valuations," Metrick and his colleagues write. The effect levels off as ownership exceeds 33%, probably because of the wealth effect. Insiders become so rich they have dwindling interest in accumulating more and prefer corporate strategies that emphasize safety over performance.

Growth in insiders' voting power had the opposite effect as growth in economic stakes. Tobin's Q declined as insider's voting power grew, with the loss bottoming out as their voting control reached 45% of the votes available to be cast. As voting power grew from zero to 45%, Tobin's Q fell by 25%. "This is consistent with the entrenchment effect of voting ownership, i.e., the more control that the insiders have, the more they can pursue strategies that are at the expense of outside shareholders," the authors write.

### **Sacrificing Performance for Control**

Similarly, sales growth improved as insiders' financial stakes grew, and worsened as they gained voting clout. The same patterns were found with capital expenditures and the expenses for research and development and advertising, with the pattern most pronounced in sales growth and advertising expenditures, Metrick said.

The data suggests that insiders with lots of voting clout are reluctant to raise cash by selling additional shares, which would dilute their influence, according to Metrick. As a result, they tend to skimp on capital expenditures and other spending that can improve results. They sacrifice some performance to maintain control.

The super shares provided such an effective barrier to hostile takeovers that dual-class firms tended to employ poison pills and other takeover defenses less than other firms.

The researchers also found that dual-class companies tended to have more debt than single-class companies. "A potential explanation for dual-class firms' heavier reliance on debt financing is that investors may be reluctant to purchase the inferior voting stock of these firms, and they may therefore have to rely more heavily on debt financing," the authors write. They conclude: "The most plausible explanation [for the study's findings] is that some firms adopt dual-class structures when their original owners are reluctant to cede control; later, these firms are less likely to tap capital markets (so as to avoid diluting control) and thus invest less, grow slower, and are valued lower."

This is not to say that every dual-class company is destined to perform poorly – Berkshire Hathaway, Comcast and many other dual-class firms have served shareholders very well. But Metrick suggests investors keep in mind the generally negative effects of dual-class ownership when they consider buying stocks like Google. “It’s possible they will get the good effects without the bad,” he said. “But it’s something they should know.”

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