Dual-Class Shares

Does Management Really Need Such Protection?

A company that has a dual-class voting plan has two or more classes of voting common stock. The difference in these classes of stock is the amount of votes allocated to each share. Many of the companies that hold these dual-class shares are well-established brand names, such as Comcast or Dow Jones. Dual-class shares allow the founding families or controlling interests of such companies to retain voting privileges and power, while simultaneously raising capital by issuing public stock. These super shares can magnify voting rights by a ratio of 10:1, or more. In fact, while most firms give investors partial rights, some extreme firms give no voting rights with the purchase of their common stock, allowing the controlling shares to retain full power over the company.

While it seems intuitive that company owners would benefit from a dual-class shares structure, one must wonder why investors choose to invest in a company in which their voice will be diminished. These investors are presumably expecting a rise in future cash flows and the corresponding value of such shares. Many of these investors may be driven by a strong belief in the management of these companies and their ability to raise profits. Davis and Lukomik, refer to this as the "reign of benevolent despots." This situation is based on the expectation that strong early stage financial performance by company founders or management creates a level of trust which allows for the initial deferment of rights in a dual-class arrangement. Problems arise however, when management experiences difficulty sustaining performance on a long-term basis.

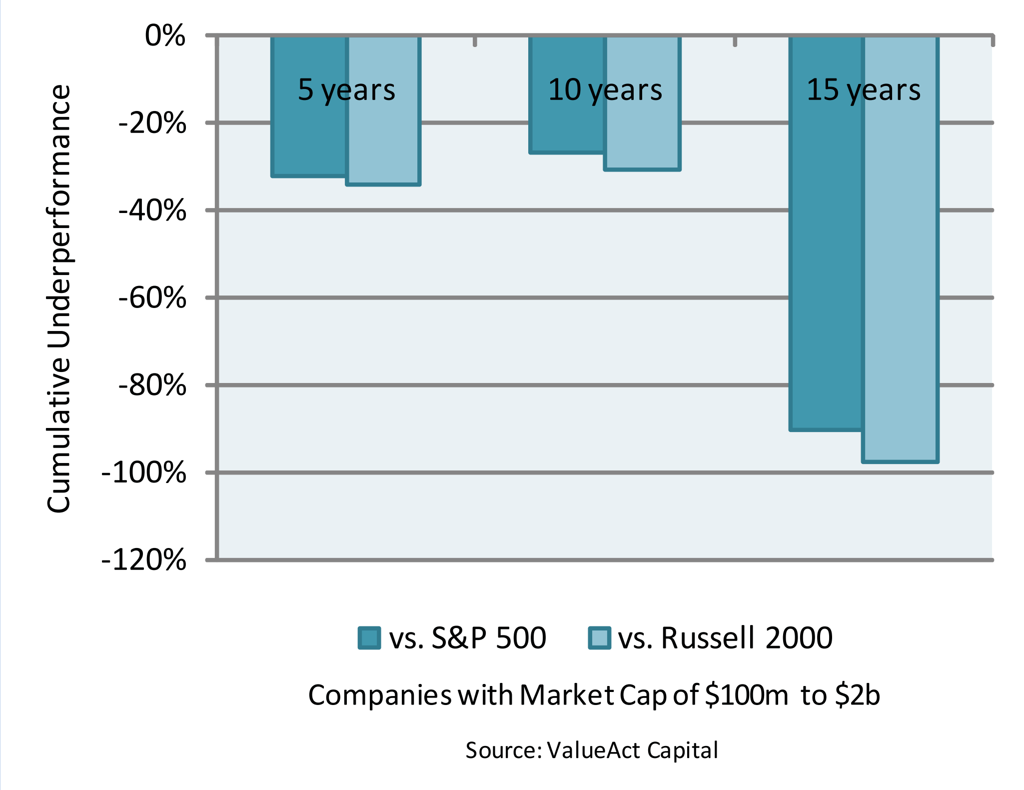
> *"Dual-class shares consistently underperform, at a cost of billions of dollars to shareholders."*
>
> David Lockwood
> Partner, ValueAct Capital

Dual-Class Scenarios

Dual-class shares can create a "win-win" scenario for management, allowing company founders or controlling interests to hold on to power even though they no longer own a majority. They are able to raise capital without a proportional dilution of voting power. These superior share structures provide protection to management when it is not needed (times of strong performance), as well as during times of management under-performance, when it may not be deserved, but very necessary for job security.

Some investors believe that companies benefit from the dual-class structure. This stance stresses that the controlling shareowner is looking out for the long-term benefit and performance of the company, not just the quarter-to-quarter earnings. This reliance on concentrated control stems mainly from the fact that controlling shareowners often have a significant portion of their own wealth at risk relative to managers of widely-owned companies. Another important issue to consider is the reputational risk born by controlling shareowners with disproportionate shareholding.

The longer a dual-class share structure is in place, the more shareowner value it can destroy...



As opposed to the "win-win" scenario for management, dual-class shares can be considered to have a "tie-lose" relationship for shareowners. When a company is experiencing challenges, the positive attributes of guaranteeing a brilliant founder additional degrees of freedom may be lost. In this instance, dual-class shares have the very real effect of constraining the board from taking action.

In addition, heirs to a business may not be as successful as original founders. One market pundit noted, "It's rare for a monarchy to boast a series of wise, benevolent ruler's generation after generation." By automatically relinquishing power over a corporation to the founding family, the company is foregoing the benefits of the competitive process. In companies without dual-class shares, power over a company is held by a broad group of investors, who may provide a more thorough industry knowledge base.

As a result, investors tend to prefer single-class share investments over their dual-class counterparts. Ka Li, Hernan Ortiz-Molina, and Shelly Zhao compared institutional investment in dual-class firms with asymmetrical voting rights to that of single-class firms where one share corresponds to one vote. The authors found several interesting relationships and conditions tied to maintaining a dual-class structure. First, they found that institutional ownership in dual-class firms is significantly lower than it is in single-class firms, after controlling for other determinants of institutional investment. Institutions of all types hold less of the shares of dual-class firms, but this avoidance is even more pronounced for long-term investors with strong fiduciary responsibilities than for short-term investors with weak fiduciary duties. Perhaps most notably, the authors found that following the unification of dual-class shares into a single-class, institutional investors increased their shareholdings in the newly capitalized firm.

A growing number of investor funds are taking a dim view of dual-class shares. David Lockwood, Partner at activist fund ValueAct Capital, believes, "One share, one vote should be a first principle of good corporate governance. A share of stock should not have fewer votes because it is owned by a pension fund or an individual investor, or more votes because it is held by management. And not just on grounds of fairness: the evidence is compelling that companies with dual share classes have significantly underperformed over time. Fortunately, there is a solution that benefits both classes of shareholders: an exchange of high vote for low vote shares at an appropriate premium. We [ValueAct] believe that such exchanges resolve the conflicts inherent in a dual class share structure and substantially increase the overall value of a firm. That benefits shareholders and management alike."

Prevalence of Dual-Class Companies

According to research firm, Governance Metrics International (GMI), only 7.7 percent of the 1,700 largest U.S. companies feature unequal voting rights. Across the broader U.S. stock market, reflected in the Russell 3000 stock index, another governance research firm, RiskMetrics Group (RMG), found only 7.59 percent of firms to have some form of unequal voting share scheme. However, the vast majority of these firms do not have freely traded equity available for purchase by any investor other than insiders or founders currently holding those shares. RMG also found that the Media, Food Beverage & Tobacco, Household & Personal Products, Consumer Durables & Apparel, and Retailing Industries had the highest proportion of dual-class stock companies within their own industry, at 35.7 percent, 11.9 percent, 9.7 percent, 9.6 percent, and 6.7 percent, respectively.

So why are dual-class shares a major corporate governance issue? While utilized by a relatively small number of companies, dual-class structures have a significant, negative impact on investor equality. Dual-class voting diminishes shareowner rights by not allowing investors to vote for the board in proportion to their investment, therefore insulating management to shareowner directions.

Over the past decade, the prevalence of dual-class companies has been fairly steadily declining, from 295 companies in 2005 to a 2009 count of 278. In addition, there has been an increase in the percentage of dual-class share companies who do not use this structure as an entrenchment device, but merely have a dual-class structure as a result of a spin-off or some other investment vehicle. In 2009, approximately 22 percent of all companies holding a dual-class share structure allowed this superior class of stock to be freely traded and did not concentrate its ownership exclusively to insiders. That is a significant shift compared to the 13 percent of dual-class share companies that freely traded their superior stock in 2006.

> *"For current or prospective directors of dual-class firms, we offer the following advice: First, if possible, work to eliminate the dual-class voting structure. In our study, firms that rescinded the superior voting rights of Class B shares experienced an immediate value gain of at least 5 percent, which we believe is almost certainly an understatement of the ultimate effect of switching from dual- to single-class stock."*
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> Scott Smart, Associate Professors of Finance, and Chad Zutter, Assistant Professor of Finance, at Indiana University, and Ramabhadran Thirumalai, Visiting Professor of Finance, University of Pittsburgh. *Directorship* - September 2007

Dual-Class Shares in the News

Although the prevalence of dual-class share structures is relatively low, companies that maintain this structure are frequently the subject of governance attention. Three companies with recent headlines regarding their dual-class share structure are TDS, Comcast, and Ford.

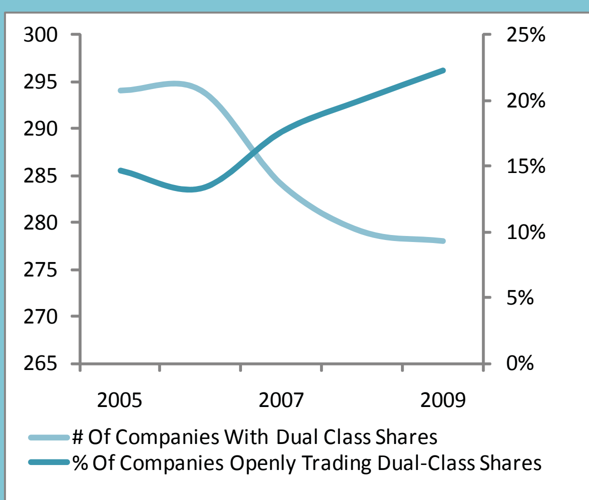
TDS

Telephone and Data Systems, Inc. recently held a shareowner proposal, sponsored by Southeastern Asset Management, for the implementation of a "one share, one vote" company stock structure. "Southeastern made its proposal in light of management's demonstrated poor capital allocation, refusal to follow value-enhancing recommendations, and its failure to disclose or pursue the premium bid for TDS from a well-resourced strategic acquirer offered in 2007." The result of this vote was an overwhelming 85.16 percent of non-management votes cast in favor of the recapitalization. It is assumed that management and the Carlson family all cast their votes against the notion of recapitalization.

The company's multi-class common equity structure has allowed TDS management to ignore the voices of shareowners. However, with the vote largely in favor of a recapitalization, the shareowners have undoubtedly let their dissatisfaction be known. O.

Mason Hawkins, Chairman and CEO of Southeastern, said “We are encouraged that independent shareowners have strongly supported our proposal to recapitalize the common equity structure of TDS, expressing their desire for a democratic corporate governance structure.” The shareowners have long been unhappy with the Carlson family’s control over TDS despite owning less than 50 percent of the shares outstanding. Now they are giving an exceptionally clear expression of the changes they desire.

The past decade saw a gradual shift away from the dual-class structure.



Source: CGQ data provided by RiskMetrics Group

Comcast’s “Comcastrophe”

Comcast has two classes of common stock. The stock available to the general public is Class A. Class B is solely owned by the Chairman, President, and CEO, Brian Roberts. This Class B super stock is entitled to 15 votes per share, while the general Class A stock receives only 0.137 votes per share. Mr. Roberts, and his family, together own Class A and Class B common stock representing 33.3 percent of Comcast’s total voting power. This in spite of the fact that he owns less than three percent of the company’s total common stock. One may ask why shareowners would invest in stock that gives them so little control. It seems as though Mr. Roberts wants the financial benefits of selling shares, but does not want to relinquish any power over Comcast.

In 2006, Mr. Roberts control was almost taken by a shareowner-sponsored recapitalization proposal that received approximately 48.7 percent support from the Class A shareowners (assuming that Mr. Roberts cast all of his Class B shares against the proposal). However, a recapitalization of Comcast shares will not soon pass due to a section of the company’s articles of incorporation which states that recapitalization of the company’s capital stock would require the approval of Mr. Roberts, as the beneficial owner of its Class B common stock. It can be assumed that Mr. Roberts is not going to approve this transformation and subsequent loss of power.

Comcast officials argue that the dual-class structure of their common stock has not hindered their ability to be profitable, pointing out that they have performed better than the S&P 500 by a margin of 2 to 1 since the company went public in 1972. With a five year comparison to the S&P 500 much less flattering, shareowners are likely to continue to voice their discontent with the structure of Comcast’s common stock. The question is whether Comcast will choose to listen.

Ford

Ford is the only U.S. automaker that did not land in bankruptcy in 2009. It is also the only U.S. automaker that is still controlled by a tight-knit family. Ford has a dual-class structure that allows members of the Ford family to have approximately 40 percent of the voting rights, while holding less than two percent of the company’s outstanding shares. This super stock grants the Ford family 16 votes per each share of stock owned.

Ford is a perfect example of the passion that can be held by founding families for their companies. Ford was having financial difficulties before the financial crisis ensued. The company neared bankruptcy, yet the Chairman of Ford, Bill Ford, cut short feelers from Toyota and was quoted as saying he “would rather pour gasoline on Ford and burn it to the ground.”

Shareowners unleashed an uproar, arguing that the board of directors was not acting in the best interest of shareowners. Objective investors may have sold part of their interest in Ford to decrease their exposure to the potential bankruptcy. The Ford family, however, did not act rationally, in terms of traditional risk-aversity. Ford leaders

Orient Express Proxy Contest to Eliminate Dual-Class Shares

October 10, 2008

Excerpts from RiskMetrics Group proxy research:

"The existence of a dual-class capital structure can lead to the entrenchment of management, create impediments to a takeover process, and cause shareowners' voting rights to be disproportionate to their economic investment in a company.

A number of recently published academic studies find empirical evidence supporting the claim that dual-class share structures are positively related with poor governance practices in listed firms. Several of the conclusions may be illustrated in the case of Orient Express. The dual-class share structure of the company essentially gives no opportunity to shareowners to hold the board accountable on any issues relating to the company through their voting rights. Furthermore, shareowners are not given the chance to have a true voice on major corporate transactions, which could potentially add a premium to the value of the company's share. The management of the company appears to be entrenched, as it may only be held accountable by itself given its super-voting rights. The company apparently blocked certain strategic opportunities without giving shareowners a chance to express their views on them.

...the [shareowner] proponents have made a strong case with regards to how the elimination of class B shares would benefit the company in terms of good governance, which may in turn have a positive effect on the firm's value."

Affiliated Computer Services Acquisition by Xerox Corporation

February 5, 2010

Excerpts from PROXYGovernance, Inc. research:

"Though the offer sported a one-day premium of more than 33%, the positive economics for Class A common shareholders were immediately overshadowed by an additional premium of $300 million, payable in Xerox convertible preferred shares, for the supervoting Class B shares. The Class B shares are held entirely by ACS founder and Chairman Darwin Deason and give him control of 43% of the voting power, despite his economic ownership of less than 5%. Deason will also receive $41.4 million in severance payments – including $17.5 million in tax gross-up payments – in the deal, in addition to the $11 million in change-of-control payments he has already received. The uneven distribution of merger consideration has sparked no fewer than nine shareholder class actions and/or derivative lawsuits.

decided that drastic measures were necessary. They decided to mortgage everything in sight, including the Blue Oval emblem, to raise $23.5 billion.

While Ford's controlling family took on great risk and leverage to maintain the company's independence, such moves were seen as prescient by many in the industry in subsequent months. The company received sufficient financing shortly before the financial crisis began and banks stopped lending. Ford received considerable praise for being the only American automaker to survive the recession without enduring bankruptcy or direct federal governmental assistance.

For the full year 2009, Ford announced a profit of $2.7 billion, its first profit since 2005. Now, on seemingly stronger ground, Ford continues to face a daunting task in addressing the paydown of its considerable debtload. Ford owes creditors approximately $34 billion, with the repayment schedule increasing from $6.8 billion this year, to $12.6 billion in 2011.

The Ford family decided to roll the dice on a turnaround at precisely the right time. If the timing had been different, however, the outcome could have been disastrous. Near-term results show strong support for the bold actions of Ford's controlling family. Longer term, with a substantial debt load, the company's prospects are still uncertain to some degree. We hope that Ford management continues to focus on long-term sustainability and profit, preferably with proportional input from all its shareowners.

Empirical Research Is Not Supportive

Most of the research on dual-class shares is focused on the impact of dual-class share structure on the five main elements of firm and market behavior. These main elements include:

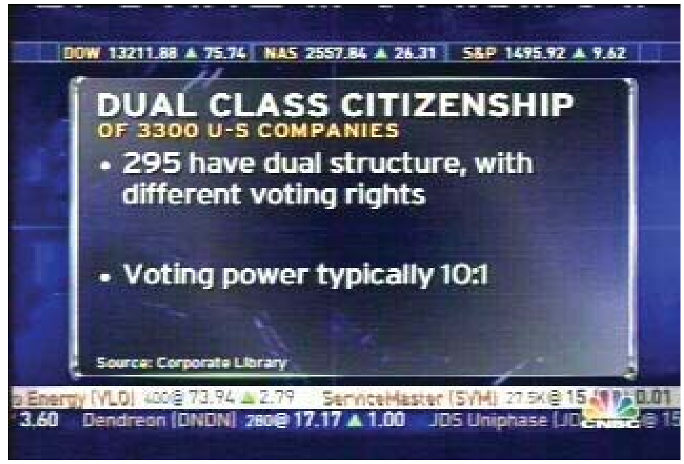
- Agency Problems
- Firm Valuation
- Earnings Management
- Investment Decisions
- Recapitalization

Agency problems have been exhaustively researched. One of the

REPRESENTATIVE COMPANIES WITH DUAL-CLASS SHARE STRUCTURES

- Blockbuster, Inc.
- Comcast Corp.
- Dillard’s, Inc.
- DISH Network Corp.
- DreamWorks AnimationSKG, Inc.
- Ford Motor Company
- Haverty Furniture Co., Inc.
- Hovnanian Enterprises, Inc.
- Kelly Services, Inc.
- K-Swiss, Inc.
- Lennar Corp.
- Liberty Media Corporation
- MasterCard Incorporated
- Molson Coors Brewing Co
- NACCO Industries, Inc.
- News Corporation
- Nike, Inc.
- Panera Bread Company
- Polo Ralph Lauren Corp.
- Revlon Inc.
- Simon Property Group, Inc.
- Sirius XM Radio, Inc.
- Sprint Nextel Corporation
- The Boston Beer Company,
- The Estee Lauder Co.’s Inc.
- The Hershey Co
- The McClatchy Company
- The New York Times Co.
- The Pepsi Bottling Group
- Under Armour, Inc.
- United Parcel Service, Inc.
- Viacom Inc.

most notable researchers is Ronald W. Masulis, a professor at Vanderbilt University. His research has indicated that, “as the divergence between insider voting rights and cash flow rights widened at dual-class companies, corporate holdings were worth less to outside shareowners; CEOs received higher levels of compensation; managers were more likely to make shareowner-value destroying acquisitions, and capital expenditures contributed less to shareowner value.” As this research shows, dual-class shares have proven to have no benefit to the shareowners. In fact, the prevalence of dual-class shares has lead to decreases in shareowner value and increases in irresponsible behavior by the controlling superior shareowners.



In 2000, Lucian Bebchuk examined the relationship between dual-class stock and corporate governance from an agency perspective. His analysis showed that the agency costs associated with such structures are higher than the costs associated with controlling shareowners that hold a majority of the cash flow rights in their companies. Authors also found the costs of these structures to be higher than the agency costs of attending highly leveraged capital structures.

Bennedsen and Nielsen (2006) found evidence supporting the argument that there is a value discount associated with firms of disproportional ownership structures. More importantly, the authors found that firms with dual-class shares had a significantly higher value discount than did firms with pyramidal ownership.

Interestingly enough, while Bennedsen and Nielsen found that dual-class shares created a significant value discount, they did not find that the presence of dual-class shares had any impact on firm operating performance. The value discount can be attributed to excess extraction of operating profits by the controlling owners. Even though the firm is operating well, investors will call for a discount due to the dual-class share structure facilitating the extraction of these large sums.

One of the main arguments for the implementation of a dual-class share structure is that allowing management to control most of the voting rights is a way of reassuring that the company can focus on long-term success instead of aiming for short-term targets. A popular scrutiny of single class share structures is that managers may try to smooth earnings to reduce their likelihood of dismissal.

Nguyen and Xu found that, “dual-class structures – characterized by higher voting rights and lower cash flow rights – can curb managers’ engagement in earnings management activities.” Avoidance of such activities may be evidenced by a smaller magnitude in abnormal accruals and a lower likelihood of meeting analysts’ forecasts.

Dual-class share structures influence investment decisions as well. This is an aspect of dual-class structures that has been extensively researched. A 2007 study found that after controlling for other determinants of institutional investment, dual-class firms had significantly less institutional ownership than did single-class firms. The avoidance of dual-class shares was most pronounced in long-term investors with strong fiduciary responsibilities. This evidence directly conflicts with the

HIGHLIGHTED RESEARCH COVERING THE EFFECTS OF DUAL-CLASS SHARES

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Southeastern Asset Management, Inc., Press Release of August 11, 2009.

suggestion that dual-class structures are beneficial for the management of the company in the long run. While companies that enforce these dual-class structures believe that they are doing what is best for the well being of the company, investors do not appear to share that belief. Dual-class share structures have a negative impact on investor confidence and institutional investment.

An increasing number of firms, especially in continental Europe, are unifying their dual-class share systems into a single equal voting class. Ironically, one of the main reasons why this recapitalization is becoming a common occurrence is to pave the way for new equity issues, which is one of the initial justifications for multiple share structures. Dual-class shares are viewed as an obvious tool to enhance managerial entrenchment.

Investors are increasingly weary of any investment vehicles that foster decreased shareowner control. Theoretically, the total market value of a company should increase after a share recapitalization because the cost of capital decreases due to higher liquidity, a wider investor base, and lower risk of expropriation. Companies that are recapitalizing their dual-class share systems into a single class are seeing increases in their market value and sales growth. In fact, one researcher, Anete Pajuste, has noted, “The firms that switched to a single share class compared to other dual-class firms are characterized by higher market-to-book ratios, larger size, higher number and size of new equity issues, and a higher number of acquisitions.”