The Perils of Small-Minority Controllers

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Discussion: Julian Franks

History of dual class shares in UK

- 1930s: Unlike Continental Europe, the UK had a complete absence of dual class shares with differential voting rights.
- 1965: 11.1% of companies listed on the London Stock Exchange had dual class shares (1950 only 3.7%). A response to the threat of hostile takeovers. Mostly family companies e.g. Whitbread, GUS, Barclays
- 1980s: dual class shares almost extinguished due to opposition by institutional shareholders & LSE (refused to subscribe for IPOs & refused listings for rights offerings). No role for company law.
- 2014 Financial Conduct Authority's listing rules amended so that new companies on the premium market permitted only one class of shares.

Basis of UK’s discrimination against dual class shares

- Dislike founded on the principle of a ‘level playing field’ and ‘fair play’’. Rooted in the rules of cricket, less on economic efficiency.
- Recent Financial Times op-ed piece: ‘dual class shares at Facebook are akin to a dictatorship’, called for outright ban on dual class shares or the introduction of sunset clauses after 2 years.
- What explains different attitudes to dual class shares in UK & US? Hint: It is not investor protection.
- Interesting contrast to bankruptcy procedures where England was until 2002 contractualist.

Bebchuk & Kastiel: their focus is on US

- 'We wish to focus on the subset of controlling minority shareholders using a dual-class structure whose stake is not merely a minority stake, but rather a 'small-minority' stake, a 'very-small-minority stake or, even a tiny-minority-stake .
- They dislike these minorities 'because they feature a unique absence of incentive alignment…This means they tolerate underperformance by the company where their private incentives offset any cost to their small private shareholdings.'
- As ownership declines the controller is willing to tolerate disproportionately larger costs to the other outside shareholders. Potential market value gain has to be relatively large to offset private benefits.

Proportion of dual class companies where controlling shareholder can exercise control with a minority equity stake of various sizes

	Incidence at Present	Potential Incidence
Controlling Minority Shareholders	96.7%	100%
Small-Minority Controllers <15%	21.3%	91.8%
Very-Small-Minority Controllers <10%	9.8%	80.3%
Tiny-Minority Controllers <5%	4.9%	34.5%

B&K's four proposals to limit influence of controlling shareholder with small stakes

- Improved disclosure of holdings held directly & indirectly
- Disclose minimum equity stake that Controller would have to hold to exercise control E.g. Snap-founder could retain control with 1% stake. Information not in the prospectus & not discussed by analysts at IPO.
- Limiting the wedge: e.g. fixing a limit on high/low vote ratio say 10:1 or introduction of 'effective' sunset clauses.
- Other forms of protection: e.g. closer judicial involvement, midstream changes to require approval by majority of non controlling shareholders

Dual class shares significantly related to family firms (80% of US founding-family firms use some form of indirect ownership, Villalonga & Amit, 2008)

- Families control over 53 percent of large listed firms in 27 countries in La Porta, Lopez de Silanes, and Shleifer (1999).
- US evidence: Family firms represent roughly 20 percent of listed Fortune 500 firms in Villalonga and Amit (2006).
- European evidence: Family firms represent 17 percent (known) or 44 percent (suspected) of all European firms. Low end: UK, 24 percent. High end: France, 65 percent. Faccio and Lang (2002).
- East Asian evidence: Family firms represent 60 percent (20 percent cutoff) of firms, in Claessens, Djankov, Fan, and Lang (2002).

What does the empirical evidence say on performance of family firms?

- If family control is held directly, firms outperform non-family ones:
  - Khanna and Palepu (2000); Anderson and Reeb (2003); Barontini and Caprio (2006); Sraer and Thesmar (2007).
- However, where families control companies via cross-holdings, pyramids and non-voting shares, under performance, because families extract private benefits of control:
  - Morck, Yeung, and Yu (2000), Claessens, Djankov, Fan, and Lang (2002); Bertrand, Mehta, and Mullainathan (2002).

Does this result hold in jurisdictions with high investor protection?

- Villalonga and Amit (2006) find a control discount in family controlled firms in Fortune 500, but 'minority shareholders are likely to be better off or at least no worse off in a family firm than they would have been in a non –family firm. Founder-CEO firms with control enhancing mechanisms are about 25% more valuable than non family firms.
- What is the size of the private benefits? Are they always negative? Are they fully capitalized into the price at the IPO stage. Selling shareholders bear the cost.

Other evidence on dual class shares:

"Some of these studies document that firm value appears to fall due to dual class capitalization but at least an equal number of studies document that firm value appears to *increase* or remains the same." (Adams and Ferreira, Review of Finance, 2008)

Evidence on dual class shares finds premiums on voting shares in high quality governance countries is virtually zero: Denmark, Sweden, Finland in Nenova (2003). Similar evidence on block premiums in Dyck and Zingales, 2004.

Gompers, Ishii & Metrick, 2010: they find 'strong evidence that firm value is increasing in insiders' cash flow rights and decreasing in insider voting rights.

Cremers, Lauterbach & Pajuste (2018), examine life cycle of US dual class firms: dual class shares survive longer, don't underperform matched sample of single class shares, wedge widens from 16 to 26% 9 yrs after IPO, & dual class shares have an 11% premium at IPO but dissipates over time.

Some observations on dual class shares

- Are private benefits always negative? Controlling shareholders better informed, able to commit to longer term relationships, & active long term owners.
- US companies with dispersed shareholders are compared favourably to dual class firms with minority control because they are subject to the disciplines of the takeover market. Is it obvious? (private benefits versus agency costs)
- Interesting that family companies retain positions on the boards of companies significantly in excess of their ownership, and even long after they relinquished any significant ownership stake e.g. Cadbury.

Conclusions

- An excellent paper.
- *Agree* with B&K's suggestions for improved disclosure, greater oversight
- Some will read their article as an attack on dual class shares generally and not just on those controlled with a small minority of shares
- Serious restrictions on dual class shares may discourage companies from listing on US exchanges. Do we care?
- Already a large decline in the *number* of domestic listed US and UK companies (>50% over 15 years) -'the partial eclipse of the public corporation'.
- Why not offer index funds with and without firms with dual class shares? Allow investors to choose.