Dual-class firms: a comprehensive literature review

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Abstract
Going public with Dual-class structure is a controversial way of accessing capital market as it deviates from one share one vote regime therefore; it is greatly criticized by investors and academicians. It is believed that insiders choose this structure to expropriate minority shareholder's wealth and to extract private benefits. These firms issue multiple classes of shares with different voting rights whereas cash flow rights are identical. This paper gives detail insight to studies carried out on Dual-class firms in the dimensions of determinants, pricing, performance and level of corporate governance. We highlighted gaps and proposed several directions for future research in these dimension.
Key words: *dual-class firms; determinants of dual-class firms; underpricing; performance; corporate governance*

1 Introduction

Firms follow one share one vote regime to access capital market whereas, accessing capital market with Dual-class structure is confrontational way, as it strays from one share one vote principal. Firms choose to list with Dual-class structure face criticism from all stakeholders. Violating one share one vote principal means, generating a class of stock which possesses different voting rights from cash flow rights. Firms obtain finance without diluting the founding owner's control by adapting Dual-class structure (D. Valentin and J. Prem 2006,[1] C. Raymond and H. John 2014.[2]). (S. Brian et al. 2009.[3]) state that Dual-class structure firms issue two classes of shares, i.e. superior voting and restricted voting shares. Insiders or officers of Dual-class firms hold superior voting shares while, public hold restricted voting rights shares. Superior voting shareholders usually have 10 votes per share whereas, restricted voting shareholders only have 1 vote per share however, cash flow and other rights are equal. (G. Paual et al. 2010.[4]) state that 85% of Dual-class structure firms have one untraded class of shares, which holds superior voting rights and on average, controls more than 60% of votes while holding only 40% cash flow rights.

Dual-class firms are still few in numbers, mainly due to prohibition of listing them on major stock exchanges (R. Kristian 1992.[5]). London Stock Exchange prohibits listing of firms with multiple classes of shares from 1968 onward, Tokyo Stock Exchange prohibits from 1945 onward, New York Stock Exchange prohibited from 1924 to 1986. The number of Dual-class firms has substantially increased after NYSE 1986 reform (A. Onur et al. 2010.[6]). (S. Scott et al. 2003, [7] S. Scott et al. 2008.[8]) state that 7% of all U.S. IPOs chose to list with multiple classes of shares from January 1990 to May 1994 accounting for 11% aggregate market capitalization. They witness that the trend of listing with multiple classes of shares increase significantly as, 12% IPOs adapted this structure to access capital market which makes 31% of market capitalization (June 1994 to October 1998). It has been reported by Wall Street Journal that 13.5% of IPOs adapted Dual-class structure in 2015, which was 12% in 2014.[9]

The debate on violation of one share one vote principal has a long history. Researchers have different opinions which can be divided into two schools of thoughts (J. Vijay et al. 2010.[10]). Researchers from first school of thought argue that insiders or pre IPO owners entrench management by holding superior voting shares, results in destruction of shareholder's value as well as affects performance of firm negatively (G. Sanford and H. Oliver 1988,[11] B. Per-Olof et al. 2007,[12] G. Paual et al. 2010.[4]). Researchers from second school of thought suggest that Dual-class structure encourages entrepreneurs and families to invest in human capital and this control over decisions leads to investment in long term value projects (B. Clas and R. Kristian 1990,[13] A. Ben and S. Brian 2001,[14] C. Henrik and N. Mattias 2003.[15]). They also argue that insiders choose Dual-class structure to avoid outside pressure of meeting quarterly requirements so; they can innovate and invest in long term value projects which are either costly or difficult to communicate to outside shareholders (B. Suman 2006,[16] W. Tian 2013,[17] C. Xia et al. 2007.[18]).

We divide literature on Dual-class firms into four major dimensions discussed extensively in the past namely; determinants of Dual-class firms, pricing of Dual-class firms, Performance of Dual-class firms and level of corporate governance of Dual-class firms. The sections 2, 3, 4 and 5 cover detail discussion on these dimensions respectively. We conclude our paper in section 6 where, we also provided directions for future research.

2 Determinants of dual-class firms

Researchers pay much attention to this dimension and tried to determine the determinants of Dual-class firms while analyzing different countries data set. It is evident from literature that those firms which possess noticeable ownership prior to IPO are most likely to choose Dual-class structure to access capital market (R. Kristian 1992,[5] D. Valentin and J. Prem 2006,[1] C. Raymond and H. John 2014,[2] Abdullah et al. 2017.[19]). (G. Paul et al. 2003,[20] S. Brian et al. 2009,[3] G. Paual et al. 2010,[4] Abdullah et al. 2017.[19]) witness that Dual-class firms are larger than single-class firms whereas (A. Ben and S. Brian 2001.[14]) do not witness size as a predictor of Dual-class firms. Insiders of Dual-class firms may use debt to satisfy the concerns of outside shareholders as, debt financing can be used as a governance mechanism to control agency cost affiliated with free cash flow (J. Micheal 1986,[21] G. Paul et al. 2003.[20]). (A. Ben and S. Brian 2001,[14] A. Onur et al. 2010,[6] G. Paual et al. 2010.[4]) state that Dual-class firms use more debt financing compared to single-class counterparts whereas (D. Valentin and J. Prem 2006,[1] Abdullah et al. 2017.[19]) do not witness significance difference in debt financing. (Abdullah et al. 2017.[19]) propose the reason that debt holding pattern of Chinese firms is different compared to other developed countries therefore; they do not observe any significant difference. It is well developed in literature that institutions invest in firms which possess adequate level of corporate governance therefore; institutions resist investing in Dual-class firms because of their deviation from one share one vote regime (N. John and S. Richard 1999,[22] B. Swaminathan and W. Sunil 2002,[23] L. Kai et al. 2008.[24]). (Abdullah et al. 2017.[19]) state that Chinese Dual-class firms possess greater institutional ownership which may be because of their weaker role in China as, it is believed that institutions in China either do not desire or have power to engage in monitoring of firm (T. Stoyan et al. 2002,[25] C. Xia et al. 2007,[18] J. Fuxiu and K. Kenneth 2015.[26]). If control of firm is held by family members prior to IPO, it is more likely that firms choose Dual-class structure to access capital market (B.

Clas and R. Kristian 1990,[13] A. Ben and S. Brian 2001,[14] C. Henrik and N. Mattias 2003,[15] C. Ranadeb and S. Hoontaek 2012.[27]).

(G. Paual et al. 2010.[4]) find that firms belonging to media industry are most likely to choose dual class structure. (Abdullah et al. 2017.[19]) find that inclusion of Chinese firm in the IT industry is a predictor of Chinese Dual-class firms. They propose that firms in IT industry largely rely on innovation and innovation does not produce financial benefits in short term so, in order to avoid outside pressure they adapt Dual-class structure. It is admitted by Google's CEO that the outside pressure of meeting quarterly requirements often pushes the company to sacrifice its long term goals.[28] We suggest that future researchers should compare the determinants of Dual-class firms belonging to different countries in order to understand common characteristics of them.

3 Underpricing of dual-class firms

Underpricing occurs when the offer price of share is below its market value. It is well developed in the literature that underpricing is done to create dispersed ownership structure, considered to be a source of generating excess demand and it is done to prevent large block holders (B. James and C. Lena 1996,[29] B. Michael and F. Julian 1997,[30] G. Paul et al. 2003.[20]). Researchers believe that control motivation is absent in Dual-class firms since, insiders entrench management by holding superior voting shares so, these firms underprice less compare to single-class counterparts (B. Michael and F. Julian 1997,[30] S. Scott et al. 2003, [7] S. Scott et al. 2008.[8]). We believe that the data set used by these studies is relatively old and may be at that investors were not fully aware of investment consequences in Dual-class firms therefore, they do not push insiders to underprice share. We believe that insiders should bear the cost of retaining control in the form of underpricing since, investors are fully aware of their investment decisions since, information is readily available in this digital era. Recently, (Abdullah et al. 2017.[19]) studied the sample of Chinese Dual-class firms and find that Chinese Dual-class firms are 30.42% more underpriced than Chinese single-class firms. Future researchers can investigate whether Dual-class firms face more underpricing by analyzing new Dual-class IPOs as, literature available on this dimension is relatively small and old.

4 Performance of dual-class firms

The literature on the effects caused by deviating from one share one vote regime on performance of firm has long history. There is a strong debate on whether disproportional voting rights enhance, harm or destroys the shareholder's value. One Group of researchers are of view that insiders of Dual-class firms entrench management to extract private benefits and to expropriate minority shareholder's wealth which results in destruction of shareholder's value (G. Sanford and H. Oliver 1988,[11] B. Per-Olof et al. 2007,[12] G. Paual et al. 2010.[4]). The another group of researchers argue that insiders choose Dual-class structure in order to invest in long term value enhancing projects which are either costly or difficult to communicate to outside shareholders (B. Suman 2006,[16] C. Xia et al. 2007,[18] W. Tian 2013.[17]).

(B. Vishaal 2014.[31]) states that Dual-class firms possess high entrenchment resulting in imposing agency cost to shareholders therefore, investors attach low value to them. Disproportional voting rights leads to poor performance and lowers the firm value (C. Stijin et al. 2000,[32] L. Karl 2003,[33] Y. Yin-Hua and W. Tracie 2005,[34] G. Paual et al. 2010.[4]). (S. Scott et al. 2008.[8]) witness no significant difference in performance of Dual-class firms and single-class firms. (B. James and C. Lena 1996,[29]) find that firms listing with numerous classes of shares are performing better in terms of both operating as well as market performance. (C. Ranadeb and S. Hoontaek 2012.[27]) find that if interests of insiders and shareholders are not aligned, it will affect performance negatively as insiders try to extract private benefits by investing in value destroying projects.

(Abdullah et al.[35]) find that Chinese Dual-class firms are performing better than Chinese single-class firms in terms of market performance. They propose that the performance is better as they have bonded themselves to higher standards of U.S. from relatively lower Chinese standards and it is evident from literature that firms which bond themselves to high standards perform better. This should be further investigated whether country laws affect the performance of Dual-class firms as (Abdullah et al.[35]) find that Chinese Dual-class firms perform better because of high standards of U.S. Future researchers may compare the performance of Dual-class firms listed on different exchanges so, that the effect of exchange laws on performance of Dual-class firms would be perspicuous.

5 Level of corporate governance

Insiders of Dual-class firms retain control in their own hands therefore, insider’s intention become doubtful. Investors may evaluate the level of corporate governance prior to make investment in Dual-class, as inequality of voting rights leads to agency conflicts between shareholders and management. (B. Vishaal 2014.[31]) conclude that directors and CEO have longer tenure compare to single-class firms even when their performance is unsatisfactory. (S. Scott et al. 2008.[8]) observe that CEO turnover due to poor performance occurs in single-class firms, not in Dual-class firms and CEO turnover is less frequent in Dual-class firms. (Abdullah et al.[36]) conclude that insiders of Chinese Dual-class firms are satisfying the concerns of investors by hiring more independent directors and by attracting more institutional investors but controlling them through controversial CEO-Chairman Duality. They also witness that as the divergence between voting and cash flow rights increases, CEO-Chairman Duality increases. They do not witness any difference in board size.

This dimension needs detail investigation by future researchers. To the best of our knowledge, the literature available on this dimension is insufficient to explain whether Dual-class firms possess adequate level of corporate governance. Researchers should also investigate whether governance level of Dual-class firms differs with exchanges on which they are listed.

6 Conclusion and recommendations

This paper reviews the literature on Dual-class firms and covered its four major dimensions discussed extensively in the past. We highlight important determinants of Dual-class firms, and we propose that study should be conducted in order to compare the determinants of Dual-class firms belonging to different countries. We also discuss literature available on pricing of Dual-class firms. The available literature on this dimension is relatively old; researchers should study pricing of Dual-class firms which have listed recently, as the era has brought up many changes in investment decisions of investors. We then shed light on available literature in the dimension of performance of Dual-class firms. We propose that in future, researchers may investigate the effect of country laws on performance of Dual-class firms. Lastly, we enlighten studies carried out measuring level of corporate governance of Dual-class firms. The literature available on this dimension is quite insufficient, future researchers may study this domain deeply to understand it.

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