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PERSPECTIVE

Dual-class stock: Will innovation trump concern?

By Sara L. Terheggen

Innovation is often the primary reason a company is able to survive… at all. This is particularly true for technology companies. When such companies are able to exploit product cycles at the right time in the market, shareholder value grows. The problem with innovation is that it favors long-term growth since it increases expenses in the near term and the amount of time required for true innovation runs counter to the short-term quarterly expectations of public shareholders. Many founders believe one solution to this dilemma is the introduction of dual-class stock.

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With the recent public filing of the registration statement for Snap Inc.'s IPO, where investors are actually being offered non-voting stock as opposed to low-voting stock which is more typical when a dual-class structure is being implemented, the issue of whether dual-class stock is the right solution to this enduring dilemma has come back to the forefront. This is amplified because of the recent solidification of institutional investor perspective with formation of the Investor Stewardship Group (ISG). Based on the current state of the market, it seems as though it will be harder and harder for companies to implement dual-class structures and be able to overcome the potential loss of investor interest in their IPOs.

What Is Dual-Class Stock?

Dual-class stock refers to the capital structure of a company, where one class of stock holds a specified amount of voting control over the other class despite having equal economic rights. The typical form is super voting stock that has some multiple over single vote stock, such as a 10-to-1 ratio.

Stock exchanges prohibit listed companies from creating dual-class stock so such a structure must be implemented at the time of an IPO. In connection with an IPO, the common stock will be recapitalized into two classes where existing shareholders will retain the high-voting stock and the low-voting stock will be offered in the IPO. Subsequent to the IPO, some companies have implemented a third class of non-voting stock. The high-voting stock allows founders to retain control over critical matters affecting the company, such as election of directors or selling the company. As might be expected, founders and investors have very different views about dual-class stock.

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The Push and Pull of Dual-Class Stock

Those who advocate for the use of dual-class stock believe such a capital structure allows the company to focus on its core values without being concerned about anyone taking over control. Founders who wish to adopt this type of structure will argue vision takes time and the short-term focus of the public markets can generate conflicts by forcing insiders to be overly concerned with quarterly results. With the rise of activism, founders also argue this structure provides them protection against the whims of activist shareholders who do not share the company's long-term vision.

Those who advocate against the use of dual-class stock — primarily institutional investors — argue dual-class stock create shareholder misalignment. They also argue shareholder value is destroyed since controlling the vote ultimately means controlling the economics.

Until recently, institutional investors have complained but certain technology companies have implemented dual-class structures anyway in connection with their IPOs, often successfully. Last month, a collective of 16 large institutional investors and global asset managers that in aggregate invest over $17 trillion in the U.S. equity markets launched the ISG and a framework of six principles the ISG believes are fundamental to good governance. One of the principles specifies "Companies should adopt a one-share, one-vote standard and avoid adopting share structures that create unequal voting rights." The establishment of the ISG is the first time so many institutional investors with so much economic fire power have come together with one voice to advocate against dual-class capital structures.

While the framework is not intended to be prescriptive, the ISG is strongly suggesting directors apply the principles to the companies on whose boards they serve and have advocated for institutional investors to incorporate the principles into their proxy voting and engagement guidelines. The framework goes into effect Jan. 1, 2018, to allow time for companies to implement in advance of the 2018 proxy season.

Considering a Dual-Class Structure? A Few Considerations

Of course, whether you advocate for or against, markets do have some influence in whether investors are willing to accept a dual-class structure particularly when it gives them the opportunity to invest in a company with a strong equity growth story and a solid management team led by a top founder. But, with establishment of the ISG, a company should carefully consider whether a dual-class structure is necessary in light of the potential downside of losing investor interest in their IPO. Outlined below are some considerations for companies to evaluate when contemplating a dual-class structure:

- Realistically assess leverage in the market to ensure a dual-class structure can be implemented without sacrificing investor interest in the IPO.
- Given the formation of the ISG and the potential for hampered institutional investor interest, founders should understand dual-class structures may result in a long-term drag on share price.
- Controlled dual-class companies consistently exhibit materially more share price volatility than non-controlled companies.
- Low-vote stock often trades at a discount because of inferior voting rights.
- Ability to raise future debt or equity in the future may be impaired.
- Role and influence of the Board may be diminished with a dual-class structure making it difficult to attract and retain independent board members.

After careful evaluation of the above considerations, a company may still insist a dual-class structure is necessary to spur innovation and maintain focus on long-term growth and vision but at least the company will understand the potential downside and be able to make an informed decision with eyes wide open. If companies want to soften their dual-class structure in an effort to appease institutional investors, implementing a sunset provision can prove useful. Sunset provisions provide the super-majority shares are automatically converted to ordinary shares upon a trigger, which can be a predetermined date or upon reaching a company milestone. Companies can also consider adding limits on the creation of new nonvoting share classes in the future. When weighing innovation over investor concern, these strategies will certainly not overcome investor concern but do provide companies with options for meeting investors closer to middle ground.

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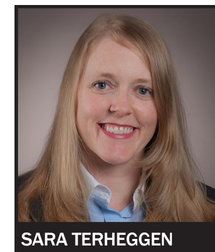
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