Will Twitter Have Second-Class Shareholders?

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By the Editors

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When a company goes public, it must tell shareholders how it plans to govern itself. The new owners are promised a piece of the profits and a say in how the company is run. The standard arrangement for apportioning control is “one share, one vote.” That’s a good, tried-and-tested design, but it seems to be going out of fashion.

Upcoming initial public offerings by two large Internet companies, *Twitter Inc.* and *Alibaba Group Holding Ltd.*, are putting a spotlight on dual-class ownership, which gives certain shareholders fewer voting rights, or none. Dual shares, often known as Class A and Class B stock, until recently were out of favor, but they are making a spectacular comeback, especially among technology companies. Google Inc. led the way with its 2004 IPO, followed by LinkedIn Corp., Groupon Inc., Zynga Inc. and Facebook Inc., which all have two or more share classes.

It’s a trend investors would be wise to resist. True, shares with inferior voting rights may cost less (the market’s way of compensating owners for their lack of control). And when disgruntled shareholders can’t oust top managers, it’s often argued, they are better able to deflect the pressure to sacrifice long-term performance for short-term return. Technology companies especially like that protective shield in the early years of public life, when ideas are more plentiful than profits.

It has worked well elsewhere: *Berkshire Hathaway Inc. (BRK/B)* has two share classes, and its long-term investors aren’t complaining. But for most companies, these arguments are outweighed by the fact that limited-voting shares make it too easy for bad managers to avoid accountability.

*Martin Lipton*, the corporate lawyer best known for helping managers stay in control with so-called poison pills, says dual-class shares ward off “myopic activists” -- hedge-fund managers and buyout specialists who aim to drive up share prices in the short term yet harm the company’s long-term interests.

Recent studies call this view into question. Harvard Law School professor Lucian Bebchuk *studied* about 2,000 companies for five years after takeover attempts, buyouts and other activists’ interventions from 1994 to 2007. He *found* that their performance improved -- and kept on improving over five years -- when compared with their peers.

Institutional Shareholder Services Inc. *found* that, from 2002 to 2012, companies with multiple share classes underperformed their peers over three-, five- and 10-year periods. They also showed greater stock-price volatility, weaker accounting controls and more conflicts in business dealings.

*Alibaba*, the Chinese e-commerce giant whose value could exceed $100 billion, unfortunately will keep the trend toward second-class shareholders going. Its founder at first wanted to list on the *Hong Kong* Stock Exchange, but that market doesn’t allow dual-class shares, so Alibaba is
coming to New York. Both the New York Stock Exchange and Nasdaq allow companies to have unequal voting rights. For now, Twitter will go against the grain and offer a single class of shares. Buried in its prospectus, however, the company says it reserves the right to switch to two classes.

Many media companies also favor them. Dissident shareholders of Twenty-First Century Fox Inc. (FOXA) (formerly part of the News Corp. media empire) are pushing Chairman and Chief Executive Officer Rupert Murdoch to give up the dual-class structure at the film and television company. Almost 70 percent of the equity confers no voting rights, while the Murdoch family’s 14 percent ownership gives them 39 percent of the votes -- and Murdoch an iron grip.

Besides Hong Kong, only Singapore among the major exchanges bars dual-class shares (and it’s considering relaxing that rule). The U.K. strongly discourages them, while other European bourses allow them.

Google, Facebook and the rest aren’t likely to return to “one share, one vote” anytime soon. That shouldn’t stop exchanges concerned about their reputations and corporate governance standards from leaning against the fashion -- perhaps by limiting dual classes to the first five years of public ownership, or capping nonvoting stock at, say, 25 percent of all shares. Meanwhile, for investors, the best advice is the same as always: Buyer beware.