First and second-class ownership

As one of the most successful football teams in the world, Manchester United is used to commanding headlines and courting the media. But when reports began emerging in August that the club would be floated on the Singapore stock exchange, no one at United was talking, not least the Glazers, the American family which bought the team in 2005.

Although there has been no official comment, Manchester United's initial public offering is expected to go ahead later this year or early in 2012 using a type of dual-share structure, with ordinary and preference shares, enabling the family to retain control while accessing finance from the market.

The Glazers' decision to use dual-class shares is unsurprising; family businesses have been using the mechanism for years. In the 1920s, while offering the public 180,000 shares in its root beer business, the Hires family retained control of the company through 3,872 "management shares" that had special voting powers.

Many other families or company founders have followed suit, choosing to list using two classes of shares — usually one with super-voting power, the other without. Under the structure, one class of share, often called class B, is worth more than the class A stock, because of the enhanced voting rights it carries. This class is rarely traded and the structure allows families to achieve a controlling position by investing a proportionally low share of capital.

"If you look at any family company that is publicly traded, that sells shares on markets, you're going to find that it's common to have some kind of dual-share structure so that a family can retain control. A family that tries to raise money in the public market through an IPO is going to take that precaution to retain control of the company," says Otis Baskin, a member of the US-based Family Business Consulting Group.

Common it might be, but not everybody is a fan of the structure. The Glazers' plans for a two-tier ownership structure has intensified critics' concerns over corporate governance at the club, an issue ever since the Glazers acquired United in a leveraged buyout that left it in debt. These critics point to other high-profile cases where the structure has caused friction, such as media conglomerate News Corporation, where the dual-share issue has been heavily scrutinised recently. Despite holding just 12% of the company's equity, Rupert Murdoch and his family control around 40% of the voting rights at News Corp.

During the phone-hacking scandal at New Corp's UK division News International, Murdoch's control of the company and the board's apparent inability to stand up to the 80-year-old caused uproar among observers who were amazed that shareholders seemed to have so little influence.

Coupled with this, a number of Murdoch's business decisions, like the acquisition of MySpace for $508 million (€380 million) in 2005 and its subsequent sale in a deal worth $35 million this year, have also been divisive, says Morten Bennedsen, an expert in family business at INSEAD, the French business school. "No one would challenge that Rupert Murdoch has made a fantastic contribution to his firm and giving him long-term ability to make decisions via the dual-kind shares was probably good.

"But it's also true now that, given that he's 80 years old, minority shareholders may be concerned about some of his decisions," he says. The system means there is no mechanism to challenge weak decisions. "To get the long-term strategies, you give up the checks and balances," Bennedsen adds.

Another well-known case where a dual-share structure caused trouble was Hollinger International, which has headed by controversial Canadian businessman Conrad Black. Black owned 30% of the equity but had 73% of the voting power, leaving other shareholders powerless to oppose his decisions. Black notoriously treated the company like a personal fiefdom, making lavish use of company money for private jets and high living — eventually leading to a conviction for fraud. "Having some voting shares or management shares or whatever you want to call them in the hands of a few people means that ultimately the accountability isn't really there," says Alexandra Sharpe, a consultant at London-based Peter Leach, a family-business consultant.

"The criticism [of dual-class shares] is fundamentally that shares ought to be on a one-share, one-vote basis – that all owners ought to be equal," says Baskin. Luke Johnson, a UK entrepreneur and the chairman of private equity firm Risk Capital Partners, goes as far as calling such structures "undemocratic". "If a business is happy to accept investors' money, they need to give those shareholders a vote. This is a basic entitlement," he says. "If I've invested in your business, then I want a say in what goes on." Other critics go even further. In 2009, when the Pritzker family said it would use a dual-share structure in Hyatt Hotels Corporation's IPO, consulting firm Green Street Advisors called the proposed corporate governance structure "the worst in our entire coverage universe".

Such concerns have led to a number of stock exchanges banning dual-share listings, including Hong Kong, which the Glazers had initially been eyeing up for United's IPO. Singapore also has strict rules governing exactly what rights come with different levels of shares. In Britain, the UK Listing Authority allows dual-class share listings, but companies that use the structure cannot have a premium listing – aimed at highlighting businesses with strong corporate governance in place. The European Commission also turned its attention to dual-class shares in the 2000s, as it focused on boosting corporate governance in companies. The Commission stopped short of forbidding companies from listing with such structures, instead introducing rules aimed at raising standards.

It's not just corporate governance that suffers either. The shares of companies that use dual-class shares often trade at a discount because shareholders worry the holder of the class B shares won't run the company in their interest. This is particularly the case in Europe, where Bennedsen says such shares are usually discounted by between 10% and 20%.

"This is not a problem when you are Google or Manchester United because so many people want to buy shares in these companies, so the small discount on the shares does not affect [the original owners]," he says. However, for smaller, less well-known family businesses that need or want to use an IPO to access finance, this could be an issue, he reckons, adding that it is ultimately the family that ends up paying for the extra control. "Families need to understand that when they list the firm with a dual-share structure, they will get a lower price for the shares," he says.

Investors in western economies are relatively unaffected by the lower share price – the shares they buy are already discounted and they remain so when sold on. However, in emerging economies like Brazil and Mexico there are growing concerns that dual-class shares could leave investors out of pocket if the family business is sold, particularly if the share sale doesn't involve tag-along rights, which let minority shareholders sell their stake if the major shareholder does.
"Unless tag-along rights have been implemented for non-voting shareholders, a change of control premium would typically accrue only to the controlling shareholder," says Eric Anderson, head of Latin American equities for ING Investment Management. "This enables a buyer to pay a high price for control without having to bid for the entire company. In this case, minority shareholders lose out."

But not everybody is against dual-share systems. Supporters argue that such structures allow the founder or those with in-depth knowledge of the company to steer the business in the right direction, taking long-term decisions rather than responding to short-term market pressures. Numerous tech companies including Google, Facebook and LinkedIn, which are headed by individuals often thought to be intrinsic to their success, have opted to use a dual-class stock arrangement, enabling the original founders and early venture capital supporters to control voting power. Many family businesses might argue that they also have knowledge of the business that couldn't be matched by outsiders. "The reality is that shareholders, even though they know that the family may appropriate private benefit of control, still buy those shares," says Raffi Amit, a professor at the Wharton Business School. "They are putting their confidence behind that family's record and that pays off more often than not," says Baskin.

They might have a point. A 2003 paper published in the Journal of Finance found that family-controlled firms outperformed other publically traded companies by 6.65% in return on assets. And there have been many other research reports that have backed this up since. A clear example of a dual-share structure where the family benefits the business is the Ford Motor Company, controlled by the Ford family through voting rights, says Baskin.

The company was able to take a "radical approach" to the recession, which included selling off Jaguar and telling Wall Street it wouldn't offer guidance until problems were resolved – a move which Baskin reckons would have been "virtually impossible" in a firm without a dual-share system. "Today Ford is the best performing automaker in the US. It never took any of the government's bailout money, it gained market share all through the recession and it is making progress today," he adds.

Taking a long-term approach has also helped national economies, Baskin says, pointing to the example of Germany. There companies are predominantly family-controlled and dual-share structures, as seen at Volkswagen, are common, as they are in much of northern Europe. Research carried out by Bennedsen and Kasper Meisner Nielsen, from the Chinese University of Hong Kong, found that 19% of German companies, 52% of Swiss firms and 62% of Swedish businesses use a dual-share structure. In Spain, which is struggling economically, they found no examples of public companies using dual-class share structures.

“Germany, while it has its problems, is certainly the strongest economy in Europe and came out of the recession quicker than others and has performed better and that’s primarily because those companies took a more long-term approach,” Baskin says. That’s not to say that countries always benefit from the approach; 25% of businesses in Ireland, another country in crisis, used dual-class shares.

That said, the share structure isn’t everything. If the Glazers push ahead with plans for an IPO at Manchester United they should prepare for big changes at the club, however much control they keep. “Even if you have absolute control as a family, you still have invited minority owners into the business,” says Bennedsen. This isn’t an issue as long as the new owners are satisfied with the way the family is performing. “But the moment there are opposing interests in which way to take the business forward, the family has to realise that it’s no longer a private, family-owned business,” he says, adding that shareholders have rights and will try to influence decisions, for example through the media, even if they have no voting power.

At the New York Times, minority shareholders have long pushed for the Sulzberger family, which controls the company, to separate its editorial input from financial decisions. There are two classes of shares at the iconic newspaper group, but each operates under a one-share, one-vote system. The only difference is that holders of class B shares have the right to appoint two-thirds of the board of directors.

“By controlling the board of directors, the family de facto controls the company because no decision gets to the shareholder without first passing through the board of directors of the company,” says Amit. While minority owners don’t dispute the family’s editorial contribution to the media business, they have challenged decisions made over the years, such as the purchase of The Boston Globe. But are those shareholders right? Diluting the family’s influence would not necessarily raise the standard of corporate governance. “Having a public company structure where every share has just one vote doesn’t guarantee that there is going to be a good board in place,” says Baskin.

And anyway, families that hold class B shares are becoming increasingly aware of the need to appear transparent. Some, such as Grupo Bimbo in Mexico, are increasing the number of independent directors on boards. “This is a way for the family to signal to the market that it manages the business in the best interest of all shareholders, not just in the interest of family shareholders,” says Amit.

It is these that are most successful, reckons Bennedsen. “It’s very important to understand from the family’s point of view that even if they keep control, they have an obligation to take care of the shareholders’ interests,” he says. “The moment they deviate from thinking of all the shareholders, it will lead to corporate governance issues.”