

Bucking the Trend: Why do IPOs Choose Controversial Governance Structures and Why Do Investors Let Them?

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Corporate Governance

- Balance of power between management and shareholders
 - Better for management to have more control? “dictatorship”
 - Better for shareholders to have more control? “democracy”
- Objective of this paper: examine evolution over time of two key governance structures, in different types of firms
 - Classified Boards
 - Dual Class

An overview of Board of Directors, classified boards

- Board of Directors
 - Tasked with monitoring management
 - If management is underperforming, directors should replace mgmt
 - If directors don't fulfill this duty, shareholders can vote against them
- Classified Board: Shareholders vote on a director only once every 3 yrs
 - **Cost:** Directors less concerned with shareholder pressure
 - Potentially less likely to fire underperforming management
 - **Benefit:** Directors less concerned with shareholder pressure
 - More flexibility to focus on LT performance (vs ST stock price changes)

An overview dual class stock

- Dual Class: There are two classes of stock, one of which generally has superior voting rights
- **Cost:** Holders of superior voting class have greater control over firm
 - Greater flexibility to maximize their personal utility (vs SH value)
 - If holders of superior class represent company insiders, they can take pet projects, consume perquisites, etc.
- **Benefit:** Mgmt less concerned with shareholder pressure
 - More flexibility to focus on LT performance (vs ST stock price changes)

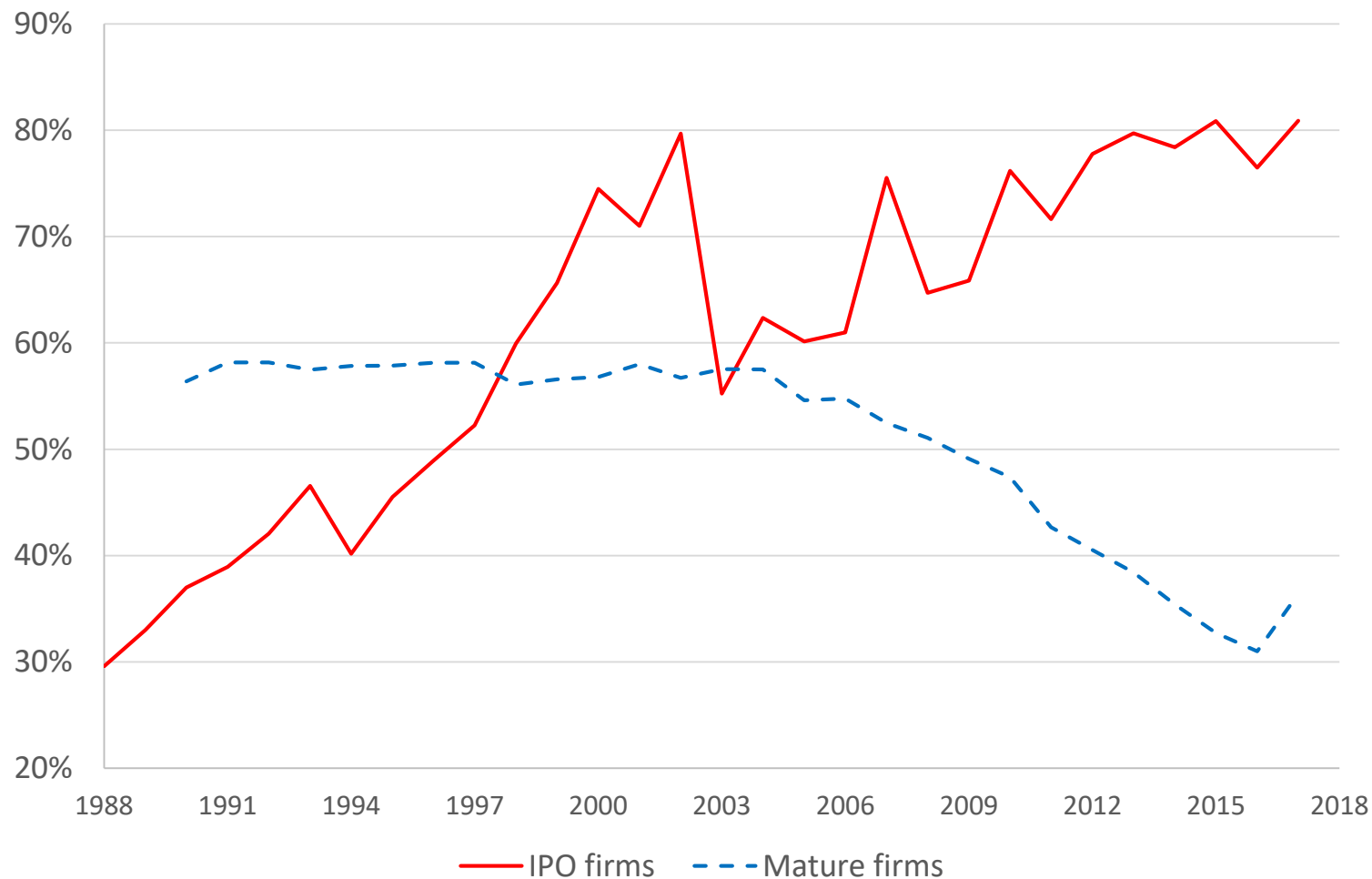
Similarities between class bds & dual stock

- Both classified boards and dual class have a cost
 - They can facilitate agency costs

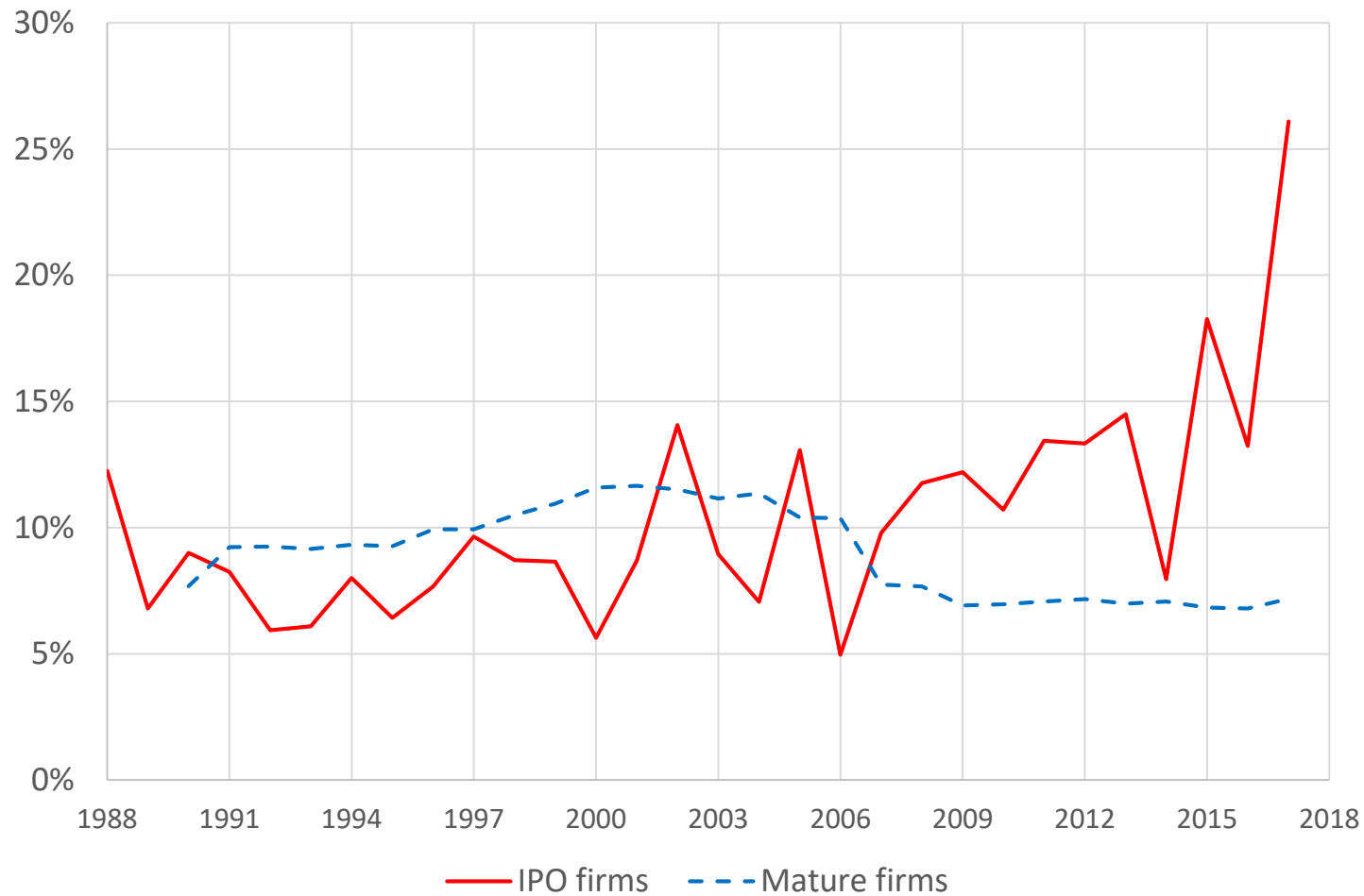
Suggests these structures will have ↓'d over time, as mkt learned more about governance
- Both classified boards and dual class have a benefit
 - They facilitate a more long-term focus on maximizing SH value
 - This benefit is greatest for high information asymmetry firms, where stock price most likely to deviate from true firm value [potentially causing unwarranted pressure for change]

Suggests that the ↓ in classified board and dual class may be less universal

Percent of firms with classified boards



Percent of firms with dual class



% of firms in industry with Classified Board

IPO firms											
	Consumer Nondurable	Consumer Durable	Manufacturing	Energy	Chemicals	Business Eqpt	Telecom	Shops	Health-care	Finance	Other
1988 - 1992	36%	33%	46%	48%	27%	37%	59%	41%	33%	43%	35%
1993 - 1995	33%	55%	45%	59%	50%	38%	44%	42%	48%	59%	46%
1996 - 2000	44%	29%	53%	47%	25%	63%	53%	57%	58%	64%	59%
2001 - 2004	64%	80%	77%	50%	75%	70%	83%	56%	79%	52%	62%
2005 - 2009	43%	29%	57%	65%	77%	74%	55%	60%	79%	63%	54%
2010 - 2013	90%	83%	83%	57%	60%	81%	71%	91%	83%	61%	75%
2014 - 2017	89%	100%	88%	71%	100%	83%	75%	84%	84%	57%	81%

Increasing

S&P 1500 firms											
	Consumer Nondurable	Consumer Durable	Manufacturing	Energy	Chemicals	Business Eqpt	Telecom	Shops	Health-care	Finance	Other
1988 - 1992	53%	57%	69%	54%	62%	45%	60%	56%	58%	56%	62%
1993 - 1995	54%	59%	69%	54%	63%	45%	59%	55%	52%	58%	61%
1996 - 2000	53%	59%	66%	52%	63%	44%	65%	60%	56%	59%	56%
2001 - 2004	50%	63%	68%	51%	66%	49%	47%	57%	55%	60%	57%
2005 - 2009	51%	62%	64%	53%	61%	45%	22%	48%	53%	51%	50%
2010 - 2013	35%	41%	54%	37%	50%	39%	15%	35%	45%	34%	40%
2014 - 2017	29%	30%	46%	28%	37%	34%	17%	26%	41%	32%	34%

Decreasing

Agency Hypothesis

- Firm insiders value their private benefits of control
 - Seek to pursue these benefits at shareholders' expense
 - IPO firm managers recognize the greater focus on minimizing agency
 - Increasingly seek to adopt protective measures while they can: pre-IPO
 - Protection is especially important in years following IPO
 - when insiders' ownership tends to fall
 - While activist pressures may eventually force firms to abandon these protective structures, mgrs will enjoy benefits for at least some time
- Increased attention to corporate governance has resulted in:
 - Activists push mature firms away from 'agency-facilitating' structures
 - IPO firms adopt these structures while they can (pre-IPO)

Optimal Governance Hypothesis

- Classified Boards and Dual Class have benefits as well as costs
 - Enable directors and managers to focus on the long-term
 - Mitigate pressures to focus on short-term stock price fluctuations / to take projects that contribute to higher short-term stock prices at expense of long-term value creation
- Benefits should be greatest among firms with highest info asymmetry
- Increases in information asymmetry of companies going public and/or increasing outside pressures to focus on short-term performance
 - -> greater tendency of IPO firms to have these structures
- Increased attention to corporate governance has pushed both mature and newly public firms closer to their optimal structures

Hypotheses are not mutually exclusive

- Differing economics between classified boards and dual class
 - Class Bds shield managers from market pressures for 2 yrs
 - Until a majority of board members can be replaced
 - Compromise b/w benefits and costs of giving mgmt more power?
 - Conjecture: Optimal Govce hyp stronger for Class Bds
 - Dual Class shields managers from market pressures indefinitely
 - Conjecture: Agency Hyp is stronger for Dual Class
- Differing economics within sample of dual class firms
 - Ability to protect private benefits of control greater if insiders have majority voting power
 - Conjecture: Agency Hyp stronger when insiders have > voting control

Empirical approach

- Thesis # 1: Paramount to understand key parameters of the gov structures
 - What is the balance of power b/w insiders and external SH's?
- *What we do:*
 - Examine distribution of insider voting rights
- Thesis #2: Endogeneity prevents direct test of value effects of CB, dual
- *What we do:*
 - Examine how mkt participants view these corporate govce structures
 - Shareholder votes
 - Examine if firms are pressured to change their govce structures
 - Board Declassifications, Shareholder proposals, Firm takeover
 - Examine other firm choices regarding governance

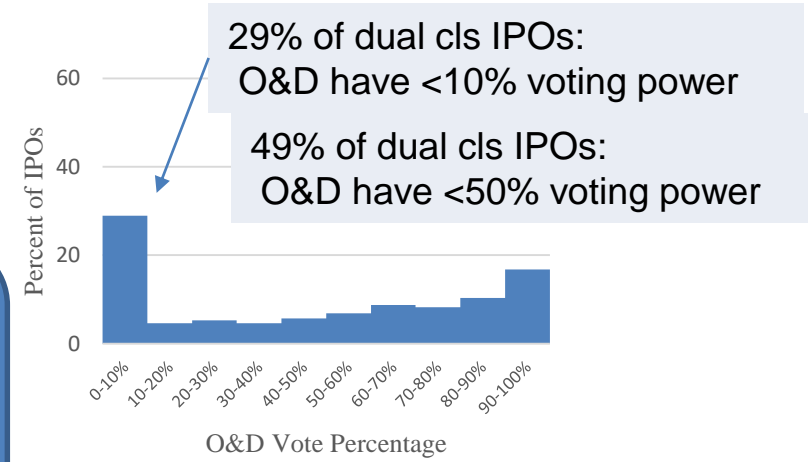
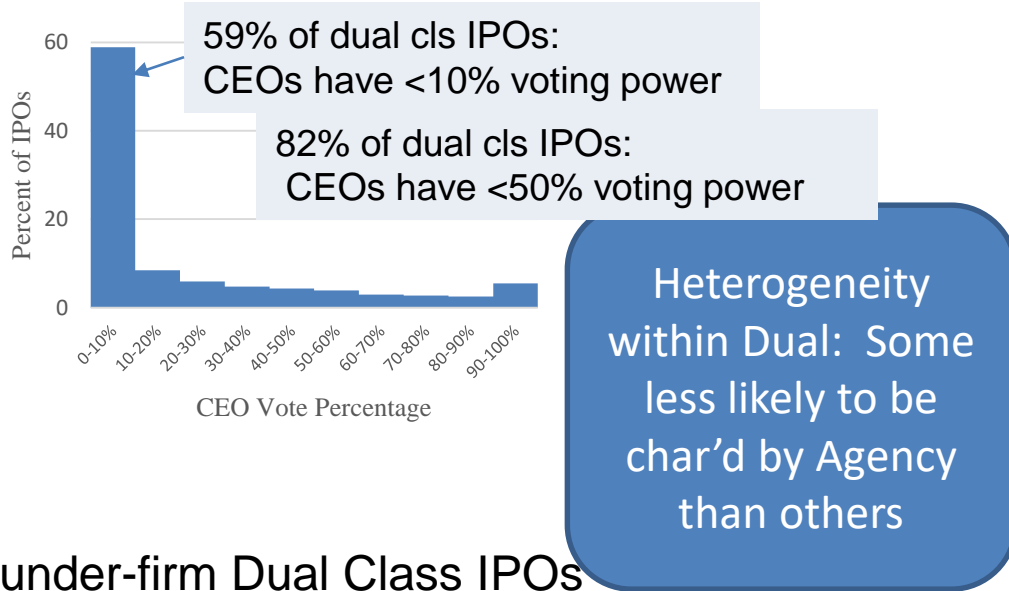
- IPOs: 1988 – 2017
 - SDC data on offer characteristics
 - Prospectuses and proxy statements for governance data
- Mature firms: 1990 - 2017
 - IRRC 1500 firms that have been public for at least 5 years
 - IRRC for governance data
- ISS Voting Analytics Data: 2006 - 2016
 - ISS recommendations on issues up for vote in firm annual meetings
 - Mutual fund votes on these issues

We begin by digging into details of Dual Class IPOs

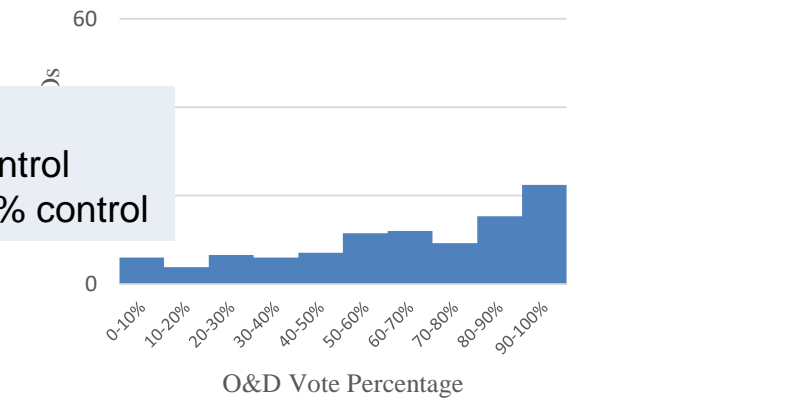
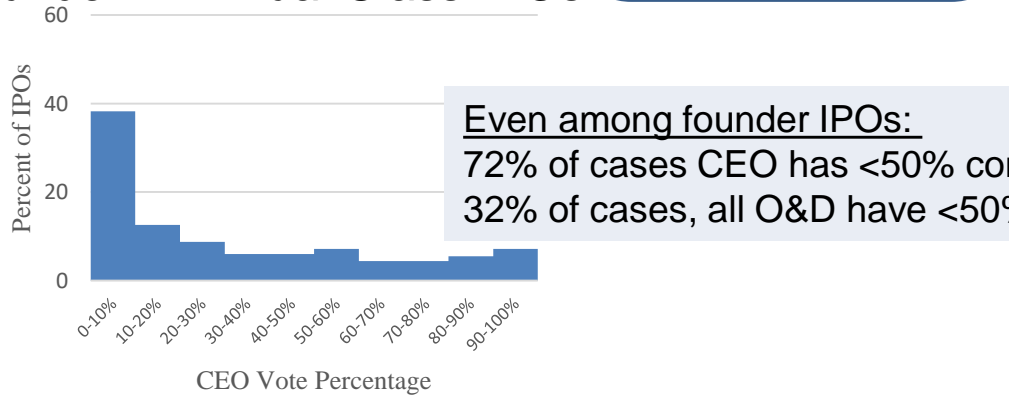
- Do insiders generally have majority voting power, in dual class IPOs?
 - Agency Hyp stronger if insiders have majority control
- We calculate insiders' voting power within every dual-class IPO
 - # classes of stock (ranges from 2 – 4)
 - # total shares of each class
 - voting rights of each class (ranges from 0 votes per shr to > 10)
 - Insiders' ownership of each class

Voting power within Dual class IPOs

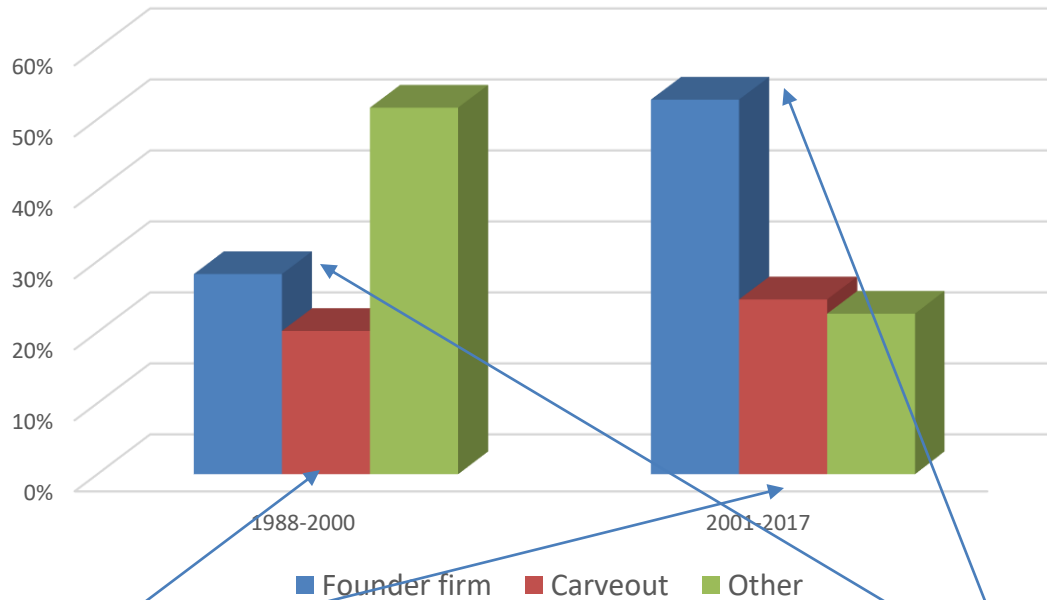
All Dual Class IPOs



Founder-firm Dual Class IPOs



Types of firms with Dual Class



- Some firms where agency less likely to be dominant factor
 - ~20% of dual class IPOs = carveouts
 - Entity with superior voting class \neq insiders

- Other firms where agency more likely to be dominant factor
 - An increasing % of Dual Class IPOs are founder firms

Test 1: Views of external market participants

- Shareholder voting = one of primary mechanisms whereby investors express (dis)satisfaction with a firm's corp govce
 - Directors up for vote every year
- Shareholder voting environment has changed dramatically over our 30-year sample period
 - Proxy advisory service companies (e.g., ISS)
 - Attention to Shareholders' votes

} Regulatory and technical changes -> increased influence
- Differences among these parties -> unique predictions of each hyp
 - Optimal Governance Hypothesis
 - Agency Hypothesis

Relevant parties' incentives to monitor firms differ

- ISS: collects & sells large amounts of data + recommendations
 - Not a shareholder – potentially less focused on firm value
 - Efforts to minimize costs -> one-size-fits-all recommendations
 - If class boards tend to facilitate agency costs in most firms
 - e.g., as found in studies of mature firms
 - Then tend to recommend against directors of all firms w class bds
- Small mutual fund families – follow these recommendations
 - Costs of in-depth research on portfolio co's > benefits
- Large fund families – devote more resources toward voting
 - Large \$ positions, economics of scale in research
 - Vote more independently, consider firm-specific factors

ISS is particularly likely to recommend against IPO firms

	All Management Proposals			Director Proposals	
Years since IPO	# Proposals	% on which ISS Recommends Against		# Proposals	% on which ISS Recommends Against
1	6,028	24.8%		4,165	24.8%
2	5,293	18.9%		3,707	20.0%
3	4,327	17.5%		2,934	18.0%
4	3,441	15.8%		2,144	13.7%
5	2,884	16.5%		1,862	15.6%

ISS is particularly likely to recommend against IPO firms

Mtgyr	IPO Firms			Mature Firms		
	# Mgmt Proposals	%Mgmt Proposals on which ISS Recommends Against	%Director Proposals on which ISS Recommends Against	# Mgmt Proposals	% Mgmt Proposals on which ISS Recommends Against	%Director Proposals on which ISS Recommends Against
2006	896	20.1%	17.6%	12,324	7.9%	6.1%
2007	1,617	16.1%	14.1%	12,944	8.7%	6.7%
2008	2,060	15.8%	11.4%	15,070	7.8%	6.0%
2009	2,058	21.5%	14.4%	15,920	12.6%	10.1%
2010	2,095	17.8%	14.1%	15,547	9.3%	7.3%
2011	2,279	22.6%	7.1%	16,007	15.1%	3.5%
2012	1,747	19.7%	12.3%	14,697	6.3%	3.6%
2013	1,699	18.0%	11.4%	15,070	6.4%	3.9%
2014	2,290	15.8%	9.7%	15,547	5.7%	3.4%
2015	2,911	20.7%	14.4%	15,920	5.9%	3.7%
2016	2,526	23.6%	17.8%	14,236	5.1%	3.2%
Total	22,178	19.4%	13.1%	154,625	8.2%	5.1%

Consistent with both Agency Hyp & Optimal Govce Hyp

Predictions

	Agency Hyp	Optimal Govce Hyp
IPO Firms	<p>Mgrs seek to protect private benefits of control.</p> <ul style="list-style-type: none"> Class bds and Dual Class exacerbate this 	<p>Have unique governance demands, due to LT projects and high info asym</p> <ul style="list-style-type: none"> Motivates firms to implement class bds, dual cls
ISS	<p>Recognize these high agency costs</p>	<p>Don't recognize unique demands of IPO firms. Follow one-size-fits all policy and more likely to:</p>
	<ul style="list-style-type: none"> Rec against dirs. of IPO firms Rec against dirs. of firms with class bds, dual cls 	<ul style="list-style-type: none"> Rec against dirs. of IPO firms Rec against dirs. of firms with class bds, dual cls
Small MFs	Follow ISS	Follow ISS
Large MFs	<p>Independently conclude that dirs. of IPO firms facilitate agency.</p>	<p>Determine that dirs. of IPO firms satisfy firms' unique gov'ce demands</p>
	<ul style="list-style-type: none"> Vote against dirs. of IPO firms Vote against dirs. of firms with class bds, dual cls 	<ul style="list-style-type: none"> Vote For dirs of IPO firms w unique gov demands (eg high info asym) Vote For dirs. of firms with class bds, dual cls

Test

Do Large mutual fund families disagree with ISS?

Are large MFs most likely to disagree with ISS among high info asym firms, who are likely to have most unique governance demands?

Subsample	% cases where Top 5 funds disagree with ISS's rec to vote against a director			
	High Info Asym	Low Info Asym	Dif.	T-stat
R&D firms (pos've R&D firms = high info asym)	64.8%	59.1%	5.6%	-3.02
Profitability (> median EBITDA/A = high info asym)	62.1%	61.1%	1.0%	0.52
Firm age (< median age = high info asym)	63.2%	60.5%	2.8%	1.46
Close to IPO (1 st 3 annual mtgs post-IPO = high info asym)	64.1%	51.3%	12.9%	5.61
VC Backing (VC backed = high info asym)	63.3%	56.8%	6.5%	3.12

Do large mutual fund families disagree with ISS?

Are large MFs most likely to disagree with ISS among high agency firms, where director choices are more likely motivated by maintaining private benefits of control?

Subsample	% cases where Top 5 funds disagree with ISS's rec to vote against a director			
	High Agency	Low Agency	Dif.	T-stat
Founder firms (Founder firm = high agency)	65.0%	60.3%	4.7%	2.26
Pre-IPO CEO Ownership (> median ownership = high agency)	60.2%	63.8%	-3.6%	1.85
CEO Tenure (> median tenure = high agency)	62.0%	60.8%	1.2%	0.62

- Where do large MFs disagree with ISS recs to vote against dirs.?
 - Among firms with high info asym (& thus unique govce demands) – YES
 - Among firms with high agency (seeking to protect private benefits) – NO
- Consistent with Optimal Govce Hyp

Is ISS more likely to rec against IPO firms with class bds, dual cls?

Sample = Director proposals in IPO firms, in first 3 annual meetings after IPO

Dept Var = 1 if ISS recommends For, 0 Otherwise

Offer Year Fixed Effects

Dependent Variable =	ISS For
Classified Board	-0.020***
Dual Class	-0.095***
Controlled co, not dual	-0.198***
R&D/A	-0.039
EBITDA/A	0.033
Log(Firm age)	-0.011*
VC Backed	-0.008
Carve-out	-0.007
Young firm	-0.022*
Founder firm	0.010
CEO Own % Pre-IPO	-0.009
Ln(CEO Tenure)	0.018***
Years Since IPO	0.020***
IR	-0.000
Ln(Assets), real 2015 \$	-0.002
Abnormal Return	0.027
MB	0.008***
Book Leverage	-0.168***
Observations	11,004

Consistent with both Agency and Optimal Govce Hyp

Do large MFs disagree with ISS recs on firms w cls bds?

Sample = director proposals, in first 3 annual meetings after IPO

Dependent Variable =	ISS For	Vote For	Vote For
Sample =	All proposals	All proposals	Props on which ISS is Against
Classified Board	-0.020*** (0.008)	-0.012*** (0.001)	-0.031*** (0.003)
Classified Board * Top 5 MF		0.017*** (0.001)	0.166*** (0.004)
Top 5 MF		0.014*** (0.001)	0.166*** (0.003)
ISS For		0.430*** (0.001)	
Dual Class	-0.095*** (0.013)	-0.000 (0.001)	0.016*** (0.004)
Controlled co, not dual	-0.198*** (0.013)	-0.010*** (0.001)	-0.008** (0.003)
Other Controls	Yes	Yes	Yes
Fixed Effects	Offer Yr	Offer Yr	Offer Yr
Observations	11,004	987,202	198,608

Non-Top5 MFs less likely to vote for firms with Class Bds (consistent with these funds following ISS recs)

Top5 MFs disagree

Consistent with Optimal Govce Hyp

Do large MFs disagree with ISS recs on firms w dual cls

Sample = director proposals in recent IPO firms, first 3 annual meetings after IPO

Dependent Variable =	ISS For	ISS For	Vote For	Vote For
Sample =	All proposals	All proposals	All proposals	Props on which ISS is against
Dual Class	-0.095***	-0.093***	-0.001	0.021***
Dual * Wedge		-0.019	-0.021***	0.002
Dual * Wedge * Top 5 MF			-0.117***	-0.300***
Dual * Top 5 MF			0.019***	0.003
ISS for			0.430***	
Classified Board	-0.020***	-0.020***	-0.008***	-0.023***
Controlled co, not dual	-0.198***	-0.198***	-0.010***	-0.007**
Top 5 MF			0.020***	0.185***
Control variables	Yes	Yes	Yes	Yes
Fixed effects	Offer Year	Offer Year	Offer Year	Offer Year
N	11,004	11,004	987,202	198,608

ISS recs not condl on size of voting-CF wedge

MF votes ARE condl on size of voting-CF wedge

Effect greatest for large MFs

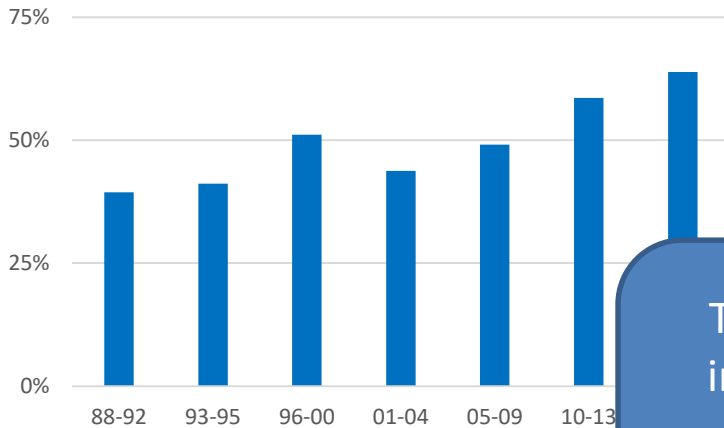
Consistent with Agency Hyp explaining most egregious dual cls IPOs

In sum

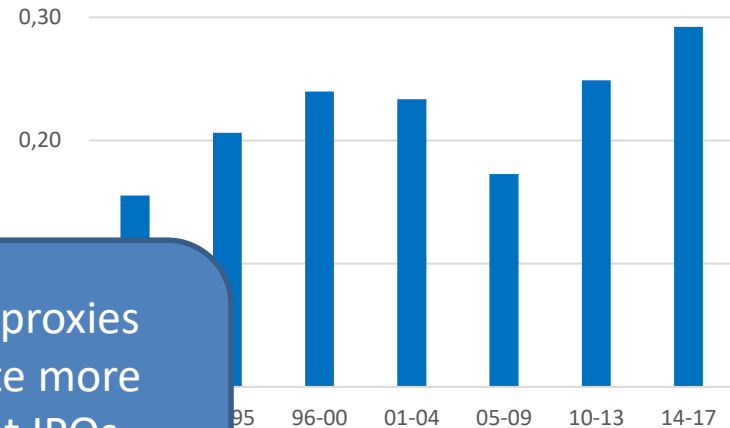
- Voting results suggest that
 - Classified Boards motivated by Optimal Governance
 - Dual class with highest insider voting rights motivated by Agency
- Dual class IPOs with high insider voting rights = small # total IPOs
 - In other words, the majority of IPO firms' governance choices do not appear to be motivated by agency
- Consistent with pre-IPO SH's such as VCs having strong incentives to sell stock at highest possible value
- Raises question
 - Have types of IPOs changed over time, such that these gov structures [Class Bds, Dual Cls w/o high insider voting rights] are more optimal?
 - Firms with higher information asymmetry, more long-term projects?

Trends in information asymmetry of IPO firms

%firms with positive R&D

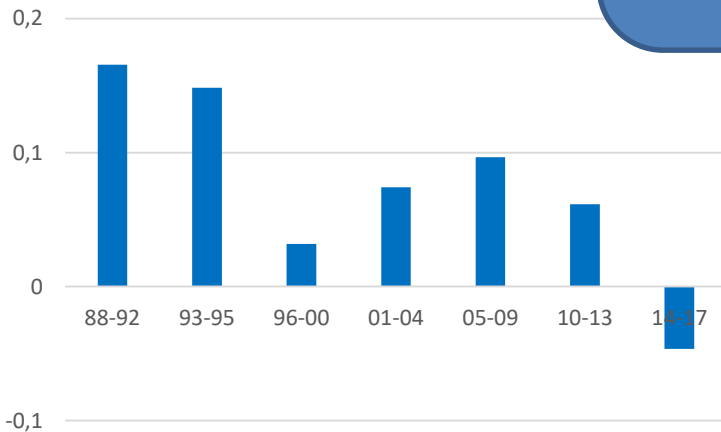


Median R&D/assets, in firms w pos've R&D

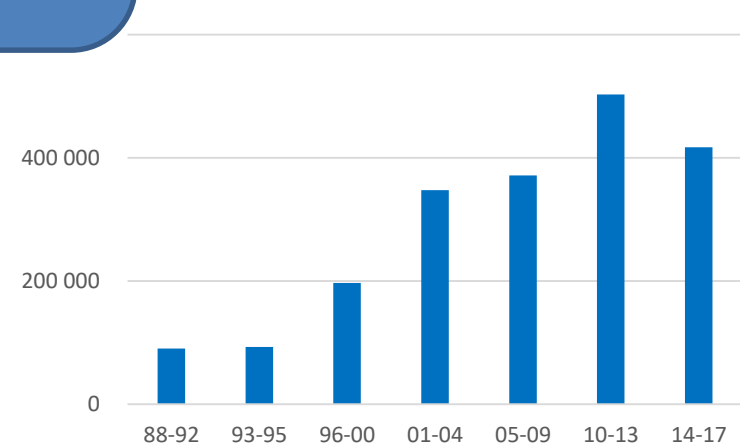


These proxies indicate more recent IPOs characterized by higher info asym

Median EBITDA / Assets

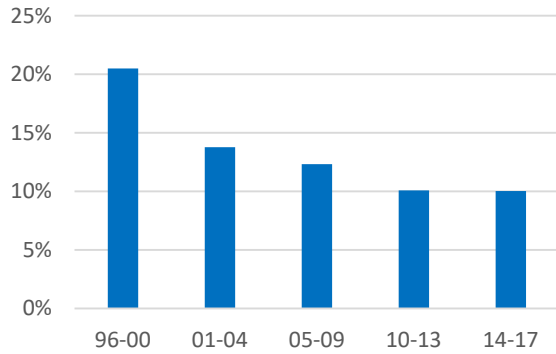


Market Cap, post-IPO

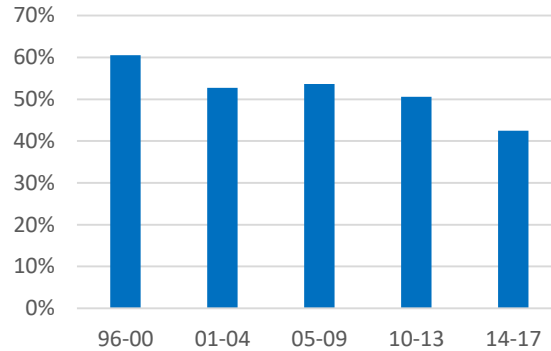


Trends in agency proxies in IPO firms

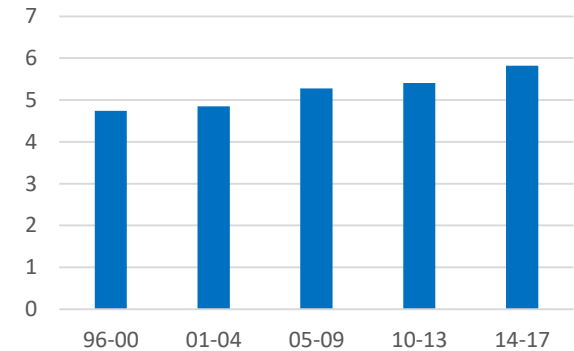
CEO Pre-IPO Ownership



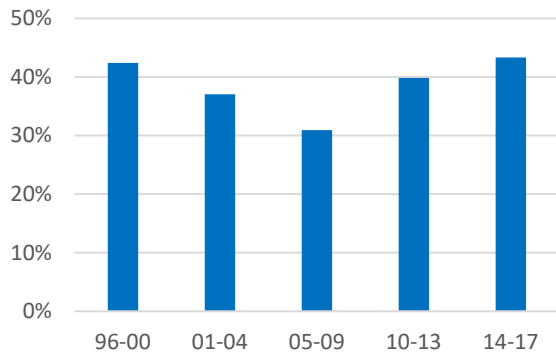
O&D Pre-IPO Ownership



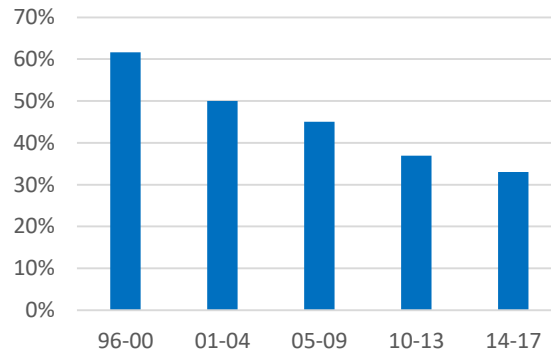
CEO Tenure



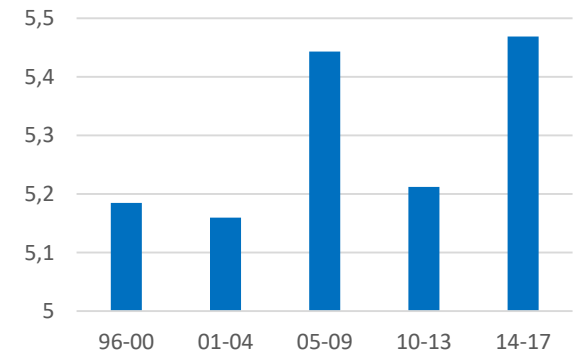
Founder Firms



CEO-Chair Duality



Chair Tenure



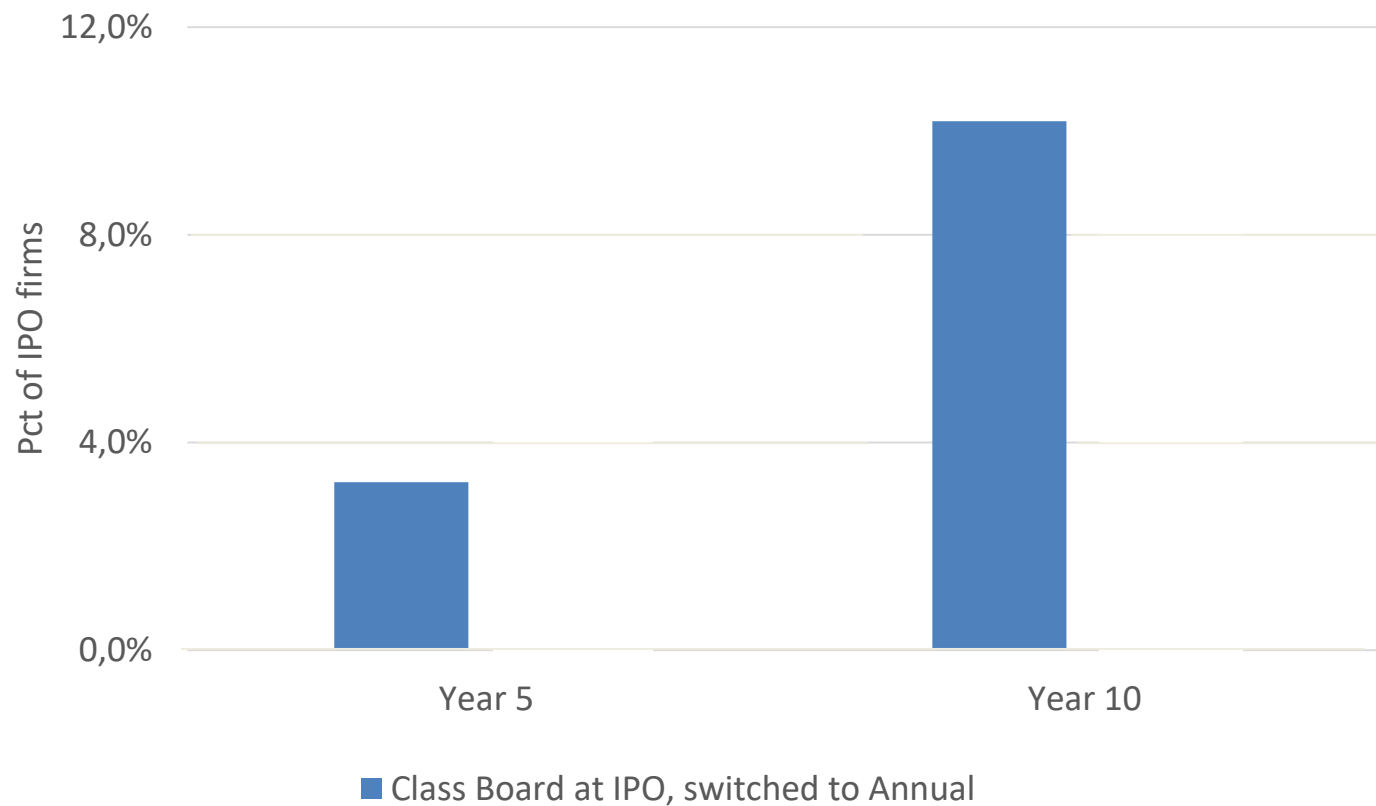
In sum, based on descriptive evidence ...

- Trends are consistent with Optimal Governance Hyp
 - Information asymmetry of IPO firms has increased over time
 - To the extent that high info asym firms have greater demands to focus on long-term
 - Benefits of class bds, dual class will be greater
- Less broad-based support for Agency Hyp
 - Less evidence that agency costs are higher in more recent IPOs

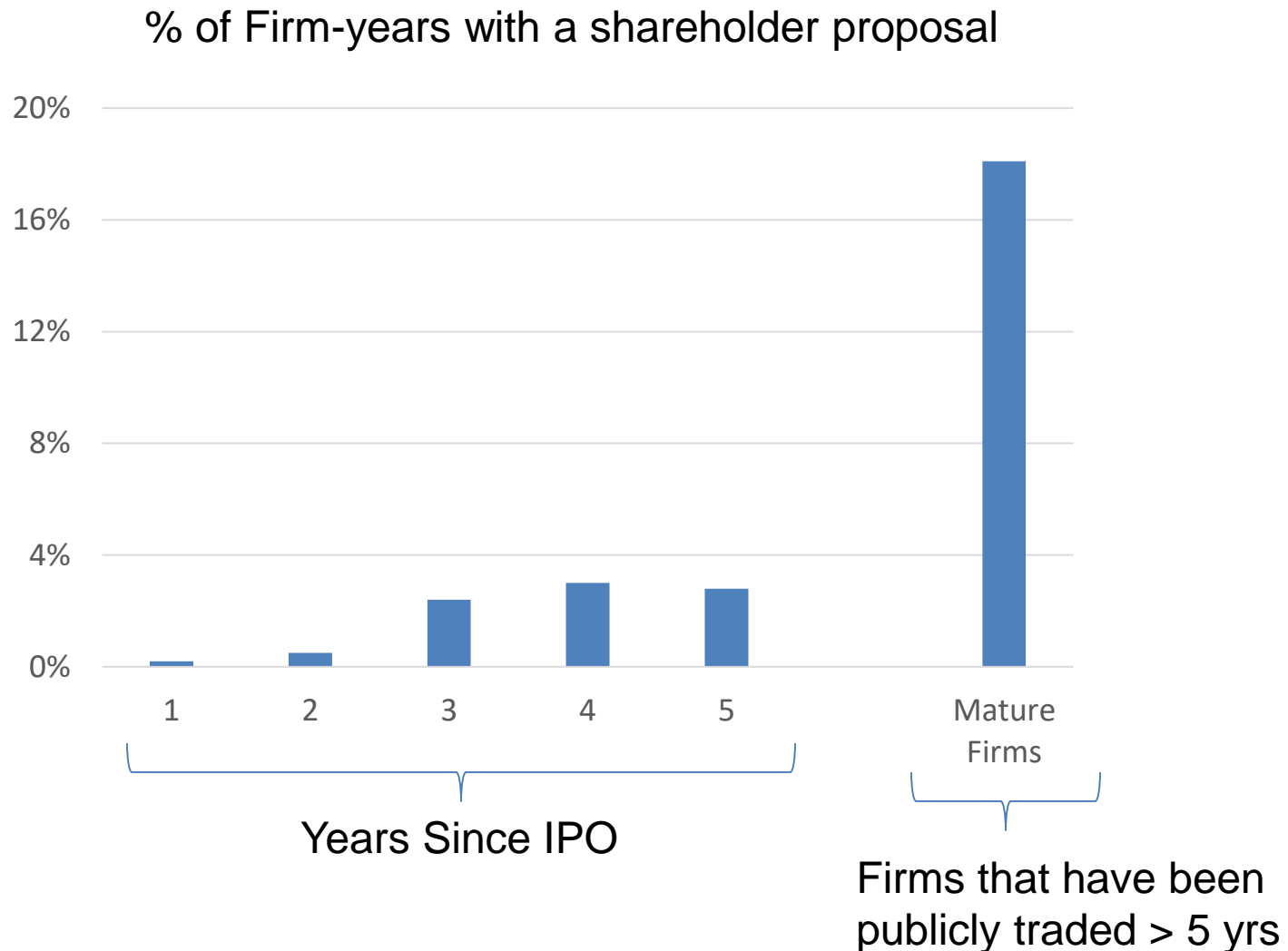
Changes in firm governance / structure in years after IPO

- Optimal Governance Hypothesis
 - If these governance choices are optimal
 - i.e., driven by unique governance demands of newly public firms,
 - Then we should see little pressure for change in years shortly after IPO
- Agency Hypothesis
 - If governance choices are motivated by agency
 - i.e., by managers seeking to protect private benefits of control
 - Then we should see pressure for change
 - Do firms declassify Boards (in cases where they had Class Bds)?
 - Do shareholders bring shareholder proposals (pressuring for change)
 - Does another co. try to acquire the firm (e.g., if firm is underperforming)
 - Where is change possible? A critical difference bw class bds & dual cls
 - Classified Boards change - Dual class prevents change

Do firms change Board structure after IPO?

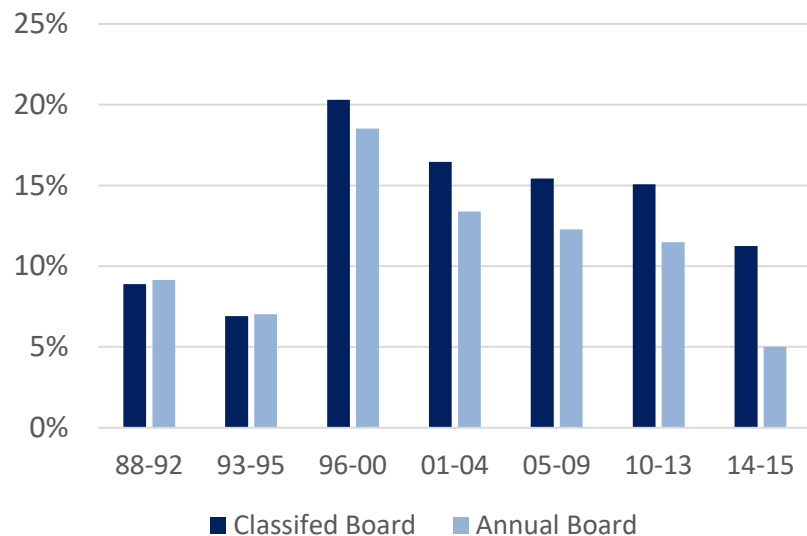


Do firms receive pressure in form of Shareholder props?

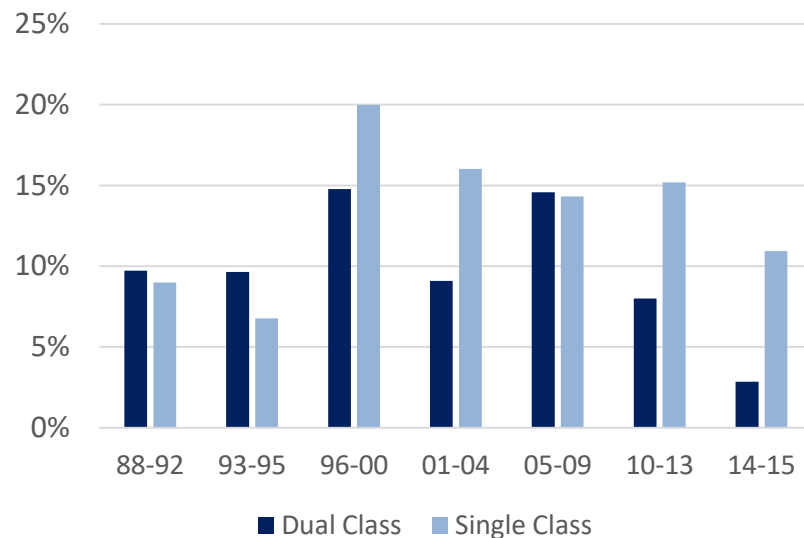


Do firms receive pressure in form of acquisition attempts?

Cond'l on Class Bd

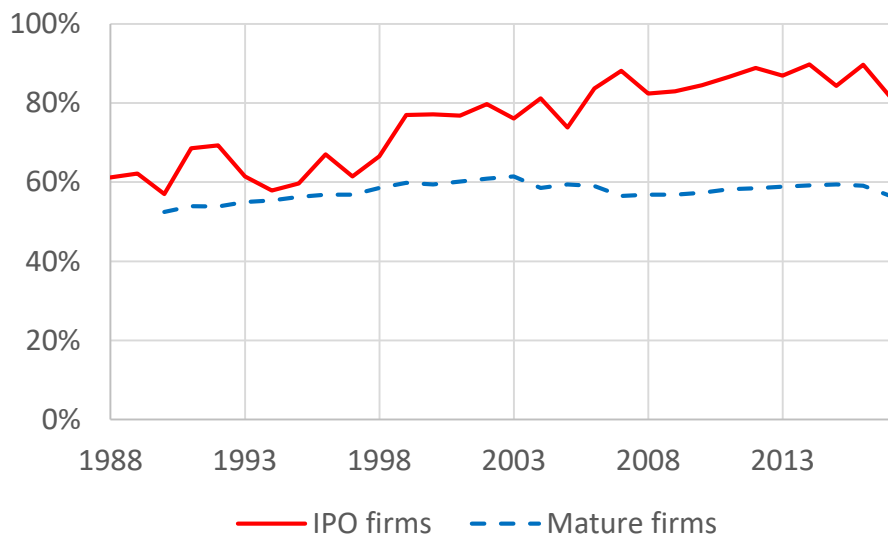


Cond'l on Dual Class

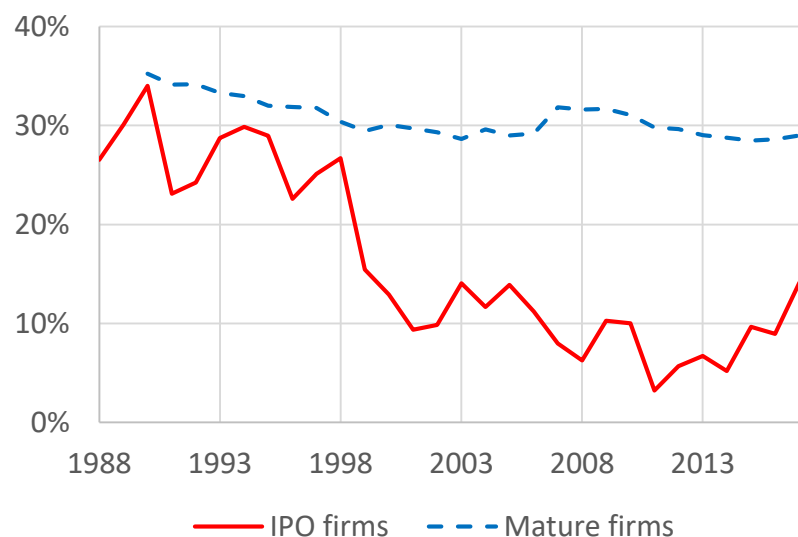


Do firms make other choices, consistent w demands for continuity?

% Firms incorporated in Delaware



% Firms incorporated in Home State



Conclusion

- Increasing tendency of IPO firms to have classified boards
 - Results most consistent with demands for stability and flexibility to focus on long-term

- Increasing tendency of IPO firms to have dual class
 - Motivations more nuanced
 - Cases where insiders have more control – Agency Hyp
 - Cases where insiders have less control – Optimal Govce Hyp