

THE SOURCE OF VALUE OF VOTING RIGHTS AND RELATED DIVIDEND PROMISES

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Abstract

This paper examines the relative share pricing of 98 firms with two classes of common stock trading in the United States from 1984 to 1999. The firms feature common stock classes with differential voting rights and, in some cases, differential rights to dividends. The observed voting premiums are higher than those reported in previous studies of U.S. firms and are dependent on the form of dividend promise to the low-vote shareholder. The voting premium is higher in the presence of a control threat, when insiders do not hold controlling voting power, and during periods of poor firm performance.

JEL classification: G32, G34

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1. Introduction:

Common stock ownership generally provides a claim to residual cash flows and the right to control the corporation by voting on certain issues. The relative value of these two ownership benefits is difficult to determine because they are typically bundled together in each share of common stock. However, some firms have separated the rights to cash flows and voting power by adopting dual-class common stock. Typically, a second class of common stock is created with limited voting rights and, in some cases, a preferred claim to dividends. The high-vote stock receives multiple votes per share and/or the ability to elect the majority of the board of directors while the low-vote stock typically receives one vote per share and/or the ability to elect a minority of the board of directors. In some cases the low-vote stock is nonvoting. Firms with dual-class stock with disparate voting rights provide a unique opportunity to measure the value of control over a firm's activities.

Lease, McConnell, and Mikkelsen (1983) study 30 U.S. firms with two classes of common stock trading from 1940 to 1978 and find that the stock class with superior voting rights trades at an average premium of 5.4%. Zingales (1995) finds a mean voting premium of 10.5% in a study of 94 U.S. firms between 1984 and 1990. Megginson (1990) studies 152 dual-class British firms from 1955 to 1982 and finds that high-vote shares trade at a 13.3% premium over low-vote shares. Rydqvist (1996) finds a 12% average premium in Sweden, Chung and Kim (1999) find a 9.6% average premium in Korea, and Levy (1982) finds that high-vote shares trade at a 45% average premium in a study of Israeli firms.

In order for high-vote shares to trade at a higher price than low-vote shares, finance

theory indicates that the high-vote shares must carry the expectation of benefits that low-vote shares do not. Thus, evidence that common stock with superior voting rights trades at a higher price than otherwise identical stock implies at least the possibility of differential cash or non-cash payoffs to the two classes. The source of these potential differential payoffs remains an unsettled issue.

One explanation is that owners of high-vote stock, who are often also managers or directors, receive direct benefit from voting control by ensuring a long-run relationship with their firm. The benefits range from the non-pecuniary (such as power, recognition, and a nice office) to the cash value of a guaranteed salary. Although this is a persuasive explanation of the source of the premiums, it does not directly explain why control premiums persist in equilibrium after insiders hold controlling power.

The market price of common stock should reflect the supply and demand of the marginal shareholders who are actively trading. While insiders clearly have incentive to prefer the high-vote shares, once they have secured their position in the firm they are unlikely to be active traders of their company's stock. As a result, the active traders in the high-vote stock will typically be non-insiders who are unlikely to qualify for the direct extraction of the benefits of corporate control. Thus, the observed premiums may reflect more than just the value of private benefits to entrenched insiders.

If the benefit of direct corporate control by insiders does not provide motivation for marginal shareholders to pay a premium for high-vote shares, then alternative explanations are needed. Two indirect benefits of corporate control for non-insiders are explored in this paper. First, non-insiders may be willing to pay a premium for high-vote stock as an option to

participate in possible premiums paid to the high-vote shares in the event of a corporate takeover. DeAngelo and DeAngelo (1985) document that 40% of the acquisitions of dual-class firms from 1960 to 1980 included negotiated premiums to the high-vote shares. The premiums ranged from 83.3% to 200%. Megginson reports that 43 out of 152 British dual-class firms were acquired between 1955-1982. Of the 43 successful acquisitions, 37 included preferential offers to high-vote shareholders. The existence of differential takeover premiums suggests an explanation for long-lived control premiums. Outside shareholders who never intend to utilize direct control may still pay a premium for high-vote shares as an investment strategy.

A second possibility of a non-direct benefit of corporate control occurs when a firm's performance slips and significant outside shareholders, such as fund managers or coalitions of individual investors, feel the need to exert pressure on management to boost performance. If a firm performs satisfactorily, then the ability to influence corporate decision-making may be of limited value. However, when profitability declines, non-insiders may place greater value on the vote as a temporary disciplinary device to improve the firm's cash flows. These non-insiders may have no interest in initiating a takeover or in becoming an insider, but simply value having a voice in how the business is run. Easterbrook and Fischel (1983) suggest that the premium of voting over nonvoting shares represents the 'opportunity of those with votes to improve the performance of the corporation.' Feldman (2000) describes a rise in shareholder activism and the increased power of individual investors to pressure for improved performance through collaboration on the Internet.

Many firms with dual-class common stock promise preferential dividends to the low-vote shareholders to encourage outside shareholder approval of the dual-class recapitalizations and to

encourage conversion of high-vote shares to low-vote shares. Dual-class stock with disparate voting rights provides an opportunity for shareholders who place a low value on corporate control to sell their votes to shareholders who place a higher value on voting. Many shareholders never vote in the corporate elections and have little interest in the operation of the firm. In contrast, insiders and large shareholders are often keenly aware of voting issues and power structures. As a result, dual-class recapitalizations with preferred dividend promises to low-vote shareholders can be viewed as mechanisms to transfer value in a mutually beneficial manner. DeAngelo and DeAngelo (1985) find that officers of firms with two classes of common stock averaged 54.8% of the voting power but only 27.6% of the claims to cash flows. Partch (1987) reports that insider ownership and voting power was 48.6% before a dual-class recapitalization. Twenty-one months after the event, inside ownership fell to 43.7% while insider-voting power rose to 58.6%.

In cases where an explicit preferential dividend is promised, low-vote shares are often promised 110% of the dividend paid to high-vote shares. In a limited number of cases, the low-vote shareholders are promised a fixed amount before the two classes share equally in subsequent distributions. The following promise by Presidio Oil is representative:

“If cash dividends are paid on Class B Common Stock, a cash dividend must also be paid on Class A Common Stock in an amount equal to 110% of the per share amount of the cash dividend paid on Class B Common Stock.”

Other firms promise the low-vote shares at least the same dividend per share as paid to the high-vote shares. This structure allows for the possibility of preferential dividends without guaranteeing them. The following promise by the Alberto Culver Company is typical:

“Class A and B are entitled to cash dividends, except that no dividends may be paid in Class B unless an equal or greater dividend is paid on Class A, and dividends may be paid on Class A in excess of dividends paid, or without paying

dividends on Class B.”

Both forms of dividend promises described above are interesting because they offer only the potential for preferred dividends to the low-vote shareholders. Even if a firm promises preferred dividends, the firm can pay equal dividends simply by paying no dividends. Similarly, firms that promise at least an equal dividend can avoid paying a preferential dividend by not paying dividends at all or by paying equal dividends. Corporate insiders who determine dividend policy tend to concentrate their holdings in the high-vote stock. Thus, there is a clear incentive and opportunity for firms to not fulfill the promise of preferential dividends to the low-vote shareholders.

In this paper, the relationship between the observed premiums on high-vote shares and firm specific variables is investigated to determine the source of the value of corporate control. We differentiate between the value of direct control by insiders and the value of indirect control by non-insiders. In addition, the value of preferential dividend promises to low-vote shareholders is investigated to determine if voting power can be purchased.

2. Analysis of Average Price Ratios:

2.1 Data and methodology

The sample includes firms with two classes of common stock that traded simultaneously on a public exchange within the period 1984 to 1999. The two stock classes must feature unequal voting rights and equal cash flow rights at liquidation. Unlike some previous studies, firms with equal and unequal dividend compensation between classes are included in the sample. The 98 firms in the sample are obtained by searching the *Center for Research in Security Prices*

(CRSP) tapes, the *Omega Research* stock database, and the *Daily Stock Price Record* books for companies with dual listings on the NYSE, AMEX or NASDAQ exchanges. Information from proxy statements is used to remove non-qualifying firms and to determine the form of the dividend promise.

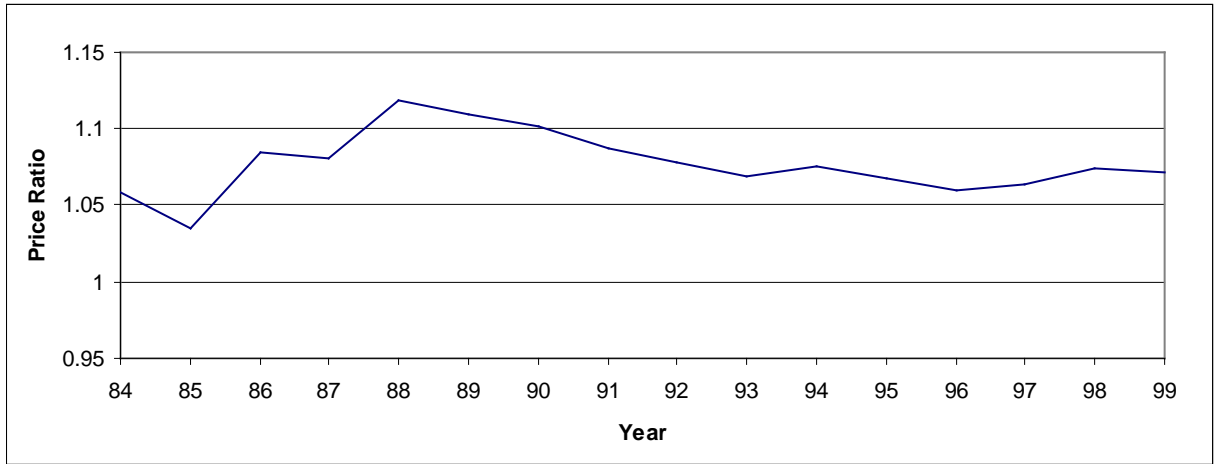
Annual price ratios are computed for each firm from every year that the firm had two stock classes publicly traded within the sample period. The numerator in the price ratio is the closing price of the high-vote stock and the denominator is the closing price of the low-vote stock. If the capital market equally values the two classes of stock then the average ratio should not be significantly different from 1.0. Market prices were collected from the *Center for Research in Security Prices* (CRSP) tapes, the *Omega Research* stock database, and the *Daily Stock Price Record* books. Because our sample follows 98 firms across 16 years, and many of the stocks that traded on pink sheets had prices that needed to be hand collected, August was randomly selected as a sample month to represent each year's price ratio. This process results in up to 16 observations from each firm and a pooled sample of 839 observations. Annual price ratios are used as independent observations corresponding with the firm specific variables that are likely to vary from year to year. Information such as dividends, insiders' percentage ownership, and traditional return measures are collected from required documents that are annually reported to the SEC.

2.2 *Results*

Figure 1 represents the average cross-sectional price ratios by year. In all 16 years the average price ratio is above 1.00 and in 15 of the 16 years the price ratio is above 1.05, clearly indicating that shareholders value voting rights. The price ratios reach a maximum during the

late 1980s corresponding to the peak of merger and acquisition activity.

Figure 1
Average Cross-Sectional Price Ratios (1984 – 1999)



To investigate the impact of possible dividend compensation for inferior voting rights, the sample firms are initially grouped into three categories based on the form of dividend promise to the low-vote shareholders. The first category includes 44 firms that promise equal dividends per share to each class of common stock. The second category contains 23 firms that promise to pay their low-vote shareholders at least the same dividends per share as paid to the high-vote class. If low-vote shareholders price this promise from insiders, this category should exhibit a smaller average voting premium than firms that promise equal dividends. The third category is composed of 31 firms that promise the low-vote class preferential dividends. Firms promising preferential dividends are expected to exhibit the smallest voting premium because low-vote shareholders will receive compensation for their inferior voting power if dividends are paid.

Figure 2 plots the time series of the cross-sectional average price ratios separated by the form of the dividend promise. Firms offering equal dividends generally trade at the highest price

ratios and always trade at a higher ratio than firms promising preferred dividends. As expected, firms that promised at least an equal dividend, generally trade at price ratios between the ratios of firms that offer equal dividends and firms that promise preferred dividends.

Figure 2
Average Cross-Sectional Price Ratios By Dividend Promise
(1984 – 1999)

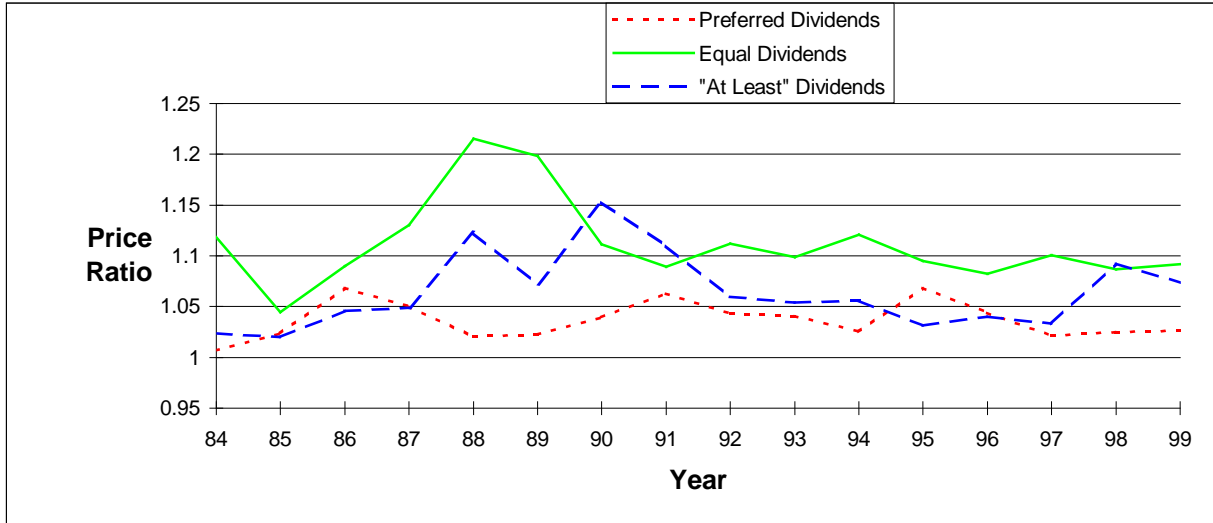


Table 1 displays the statistical results of the price ratios for the entire sample and grouped by categories based on dividend promises. Firms that promise equal dividends to both classes average an 11.1% annual voting premium, which is much larger than the 5.4% premium reported by Lease, McConnell, and Mikkelson (1983) for similar U.S. firms from 1940 to 1978, but is similar to the 10.5% mean premium reported by Zingales (1995) for dual-class firms from 1984 to 1990. The average annual voting premium for firms that promise at least an equal dividend is 6.5%. Firms that promise preferential dividends average a 3.8% premium. The average annual premium for all observations in the sample is 7.7%. In all cases the means are significantly different from 1.0. In addition, analysis of variance reveals that the mean price ratios by category of dividend promise are significantly different from each other at the 1.0%

level. This is in contrast to Zingales (1995) who finds the average premium for companies with equal dividend rights is only slightly larger than the mean of his entire sample.

Table 1
Average Price Ratios Grouped By the Form of Dividend Promise
(1984 – 1999)

	# of Firms	# of Annual Observations	Mean Price Ratio	<i>t</i> -value on Difference from 1.0
All Firms	98	839	1.077	12.85**
Firms that Promise Equal Dividends	44	356	1.111	9.38**
Firms that Promise at Least an Equal Dividend	23	243	1.065	7.91**
Firms that Promise a Preferred Dividend	31	240	1.038	5.62**

** Significant at the .01 level.

Apparently, the low-vote shareholders believe, and therefore price, the promises of preferential or potentially preferential dividends. This result is interesting given that insiders tend to hold the high-vote stock and thus appear to lack incentive to pay preferential dividends to the low-vote shares. In fact, they can choose to pay equal dividends to both classes when they promise at least an equal dividend, and they can pay no dividends at all when they promise a preferential dividend. We further discuss the issue of dividend promises and look at actual dividend behavior in Section 4.

3. The Impact of Firm Specific Variables:

Although it is well established that voting rights have value, the source of benefits to marginal shareholders has not been fully explored. One benefit to non-insiders of holding high-vote stock is the possibility of receiving preferential takeover premiums. However, non-insiders

may also benefit by using voting power to exert disciplinary pressure on insiders to improve performance without a direct takeover threat. We use pooled annual data from all firms from 1984 to 1999 to investigate the impact of firm specific variables on the value of corporate control. In addition to controlling for the form of dividend promise, we measure the impact of: the presence of a control threat, differences in liquidity between the stock classes, the relative voting power of the high-vote stock, the percentage of insider ownership, and firm performance. Equation 1 represents the regression model. Discussion of the formulation of each variable and the expected results are presented in the subsections below.

Equation 1:

$$V_{i,t} = \alpha_0 + \alpha_1 \text{ATLEAST}_{i,t} + \alpha_2 \text{PREFERRED}_{i,t} + \alpha_3 \text{CONTROL}_{i,t} + \alpha_4 \text{LIQUIDITY}_{i,t} + \alpha_5 \text{VOTING}_{i,t} + \alpha_6 \text{INSIDER}_{i,t} + \alpha_7 \text{PERFORMANCE}_{i,t} + \varepsilon_{i,t}$$

3.1 *Dividend promises (ATLEAST) (PREFERRED)*

We control for the form of dividend promise with dummy variables representing the promise of at least equal dividends (*ATLEAST*) and the promise of preferential dividends (*PREFERRED*). Consistent with the results presented in section 2.2 above, the promise of extra cash flow is expected to compensate shareholders for reduced voting power and negatively impact the voting premium.

3.2 *Control threats (PLAY)*

Although most firms promise both stock classes equal distributions during liquidation, shareholders may be offered differential premiums in an acquisition. While some European countries prohibit or restrict two tier and differential bids, U.S. laws do not require that a bid for controlling shares be extended to all shareholders. Bergstrom and Rydqvist (1992) develop a model of the optimal bid prices for voting and non-voting shares in corporate acquisitions. The

previously documented existence of differential takeover offers suggests that non-insiders may be willing to pay a premium for high-vote stock as an option to participate in the profits from possible future control contests. Privately commissioned studies by investment advisors to two of our sample firms confirm that preferential payments to the high-vote shares continue to exist in recent control contests. In reports referenced in the sponsoring firms' proxy statements, Duff and Phelps Inc. and Allen and Company Inc. find, on average, that premiums were paid to the high-vote shares in 15% of takeovers during the late 1990s. In addition, they find that premiums were paid to the high-vote shares in 40% of reclassifications back to one class of common stock.

We test the impact of increased expectations of a takeover on voting premiums. The variable *PLAY* is a dummy variable indicating the presence of a control threat. It is constructed by using the *Dow Jones News Service* and *LEXIS NEXIS* to conduct an electronic search for relevant news stories from a wide variety of business sources, including the *Wall Street Journal* and *Barrons*, for news of actual or rumored control contests within the calendar year before each observation. Specifically, we searched for the key words: takeover, buyout, acquire, and tender. Control contests were liberally defined and many did not result in an actual change of control. In some cases, the takeover pressure came from outside the firm with either a formal offer or news that an outsider had acquired a significant block of stock and was considering an offer. In other cases, the pressure came from within the firm as management groups announced their intent to obtain greater control and perhaps take the firm private. *PLAY* is expected to increase the voting premium as the probability of differential cash flows to the high-vote shares increases.

3.3 *High-vote voting power (VOTE%)*

All firms in the sample have high-vote and low-vote stock. However, the percentage of voting power held by the high-vote shares is different between firms and should be controlled for in a regression explaining the voting premium. The variable is defined as the fraction or proportion of the total number of board of directors that is elected by the high-vote shareholders. If the high-vote shareholders are simply given more votes than the low-vote shareholders then that ratio is used. For example, the variable equals 1.0 if the low-vote stock has no voting power. The variable equals 0.9091 (10/11) if the high-vote stock gets ten votes while the low-vote stock gets one vote. The coefficient on this variable is expected to be positive as more voting power should result in a greater voting premium.

3.4 *Insider Ownership (INSIDER%)*

INSIDER% is defined as a dummy variable that equals 1.0 if the total percentage voting power of insiders is greater than 40%. This information was found by examining annual proxy statements. In general, the number reflects the total voting power from the ownership of both classes of common stock of all directors and executive officers as a group. Based on the SEC guidelines, it also includes the voting power of individuals and trusts that are related to, or allied with, an insider or director.

INSIDER% is constructed as a non-linear variable because Jarrell and Poulsen (1988), Morck, Schleifer, and Vishny (1988), and others find a non-linear relationship between management ownership and market valuation. This variable is expected to be negative because voting rights have less marginal impact and are worth less when a group of insiders already effectively control the firm. Further discussion of the formulation of this variable and the choice of 40% as the cutoff can be found in Section 3.7.

3.5 *Liquidity (LIQUIDITY)*

The price ratio of dual-class stock is generally assumed to be a function of voting power and expected cash flows. However, the price ratio may also reflect differences in the liquidity of the two classes of stock. Beiner and Gibson (1999) argue that liquidity risk affects shareholders' willingness to invest in stocks and should be reflected in their prices. Megginson (1990) finds that low-vote shares are more actively traded than high-vote shares in his study of British dual-class firms and Zingales (1995) reports the volume in the high-vote stock is less than half the volume of the low-vote stock on average. In this study, high-vote shares are often thinly traded compared to low-vote shares and, on average, the low-vote shares trade at 5.32 times the volume of the high-vote shares.

The *LIQUIDITY* variable is constructed by subtracting the high-vote volume from the low-vote volume. This variable was also constructed as the ratio of the high-vote volume to the low-vote volume and using logarithmic transformations. The various specifications of the liquidity variable did not change the results significantly so we used the most intuitive definition. Larger values of this variable should result in relatively higher market values for the low-vote stock compared to the high-vote stock. Thus, this variable is expected to have a negative impact on the price ratio of the high-vote to the low-vote stock.

3.6 *Firm performance (PERFORMANCE)*

Voting rights should have value if they provide the shareholders the opportunity to exert pressure that improves performance and increases the value of the future cash flows, even if there is not a direct threat of a takeover. If the value of market discipline increases as a firm's

performance slides, then the price ratio should be negatively correlated to measures of the firm's profitability. To test this hypothesis, the *PERFORMANCE* variable is constructed in three ways using data from the *Compustat* database (*Research Insight*). First, the Return on Total Assets (ROA) is calculated for each firm from each sample year. ROA measures the performance of management given the assets that are in place without regard to how they were financed. If this number is lower, then the value of the vote and the option to intervene should be higher. The variable is also constructed using the Return on Total Equity (ROE) which measures the performance of the firm given the amount of shareholder investment. Again, the lower the number the greater the need for market discipline and the greater the expected value of the vote. Finally, *PERFORMANCE* is constructed using the actual return on common stock from the sample year. The return on the common stock includes the dividend yield, if any. An inverse relationship is expected between a firm's stock performance and the value of corporate control.

3.7 Results

Pearson correlation coefficients calculated between each of the independent variables show no significant correlations and hence, no potential problems with multicollinearity. The results from the ordinary least squares regression represented by Equation 1 are presented in Table 2. Three regression results are shown, each using a different measure of *PERFORMANCE*.

Earlier we reported that the form of the dividend promise effectively reduced the voting premium by allowing insiders to purchase some of the value of the vote. Those results are confirmed here as the coefficients for *ATLEAST* and *PREFERRED* are significantly negative. Promising at least an equal dividend to the low-vote shareholders reduces the voting premium by approximately 3% while promising preferred dividends reduces the premium by over 7%.

The *PLAY* variable, which directly tests whether the possibility of a takeover affects the voting premium, is positive and highly significant. In fact, the coefficient indicates that the presence of a control threat increases the voting premium by more than 23%. Thus, the possibility of a takeover premium provides strong incentive for outside shareholders to pay a premium for high-vote shares even when they have no interest in actual control of the firm.

Table 2
OLS Regression Results Explaining the Annual Price Ratios of the High-Vote Stock
Divided by the Low-Vote Stock for 98 firms from 1984-1999

Independent Variable	Coefficient (<i>t</i> -value)	Coefficient (<i>t</i> -value)	Coefficient (<i>t</i> -value)
Intercept	1.058** (22.65)	1.063 (22.53)**	1.070 (22.62)**

<i>ATLEAST</i>	-0.030** (-2.34)	-0.033** (-2.44)**	-0.035** (-2.53)**
<i>PREFERRED</i>	-0.076** (-5.69)**	-0.072** (-5.37)**	-0.074** (-5.45)**
<i>PLAY</i>	0.233** (13.48)**	0.237** (13.62)**	0.243** (13.94)**
<i>VOTE%</i>	0.063 (1.26)	0.047 (0.93)	0.043 (0.86)
<i>INSIDER%</i>	-0.029** (-2.62)**	-0.030** (-2.68)**	-0.030** (-2.63)**
<i>LIQUIDITY</i>	-1.319E-08 (-1.37)	-1.031E-08 (-1.06)	-0.856E-08 (-0.88)
<i>PERFORMANCE</i> (ROA)	-0.003** (-4.98)		
<i>PERFORMANCE</i> (ROE)		-8.542E-05 (-2.72)**	
<i>PERFORMANCE</i> (Return on Stock)			-2.955E-04 (-2.17)**
Adjusted R ²	.234	.218	.215
F Value	37.68**	34.51**	34.02**
Observations	839	839	839

** Significant at the .05 level.

This table reports the results of the following equation:

$$RATIO_{it} = \alpha_0 + \alpha_1 ATLEAST_{it} + \alpha_2 PREFERRED_{it} + \alpha_3 PLAY_{it} + \alpha_4 VOTE\%_{it} + \alpha_5 INSIDER\%_{it} + \alpha_6 LIQUIDITY_{it} + \alpha_7 PERFORMANCE_{it} + \varepsilon_{it}$$

where,

RATIO is the price of the high-vote stock divided by the price of the low-vote stock for the sampled trading day.
ATLEAST is a dummy variable that equals 1.0 if a firm promises at least equal dividends to low-vote shares.
PREFERRED is a dummy variable that equals 1.0 if a firm promises preferential dividends to low-vote shares.
PLAY is a dummy variable that equals 1.0 if there is evidence of a control issue during the sample year.
VOTE% is the percentage of voting control held by the high-vote shares.
INSIDER% is the percentage of total voting power held by corporate insiders.
LIQUIDITY is the trading volume of the low-vote shares minus the trading volume of the high-vote shares.
PERFORMANCE is the sample firms' economic performance measured by ROA, ROE, and Return on Stock.

The *VOTE%* variable is positive as expected but not statistically significant. In most cases the high-vote shares carry sufficient voting power to assure that control of the firm will come through that class of stock. Thus, it is not surprising that the relative voting proportion of the high-vote stock does not add significant additional explanatory power in predicting the level of

the voting premium.

The *INSIDER%* variable is significant and negative indicating that when insiders control at least 40% of the voting power firms exhibit lower voting premiums. This variable is also significant if the dummy variable is defined at any point between 30% and 55%. This result is consistent with the non-linear relationship between corporate value and insider ownership reported by McConnell and Servaes (1990). In contrast, Megginson (1990) finds that the voting premium is positively and linearly related to insider holdings of high-vote shares in British firms. In our sample, when *INSIDER%* is expressed as a linear variable the coefficient is not significant.

The *LIQUIDITY* variable is negative as predicted, but it is not statistically significant. The economic significance of this coefficient is also rather small. These results agree with those of Lease, McConnell and Mikkelsen (1984), Zingales (1995), and Chung and Kim (1999). If anything, liquidity concerns result in understated voting premiums.

The *PERFORMANCE* variable is significantly negative in each of its three specifications. ROA is the most significant and, arguably, the best measure of short-term management performance. ROE is a function of long-term financing decisions, and the return on the stock is influenced by overall market conditions and fluctuations. All variable specifications are also significant when the values are lagged by one year. Poor firm performance clearly increases the value of corporate control. It should be noted that the impact of these *PERFORMANCE* variables is statistically significant even with the presence of the *PLAY* variable in the same regression. This suggests that the value of corporate control and market discipline includes more than the direct threat of a takeover. High-vote shares have an option that low-vote shares do not: a

potential real impact on how the business is run which is particularly valuable when performance declines.

4. Preferential dividend promises and payments

The previous sections of this paper document that preferential dividend promises are priced by shareholders and thus, reduce the price ratios between dual-classes of common stock. This result raises three fundamental questions. First, why do insiders promise preferential dividends to low-vote shareholders? Second, why do low-vote shareholders believe that preferential dividends will be paid? Third, do firms actually pay preferential dividends?

These questions arise because insiders appear to have the ability and the incentive to withhold dividends or choose not to pay preferential dividends. Insiders tend to hold the high-vote, low-dividend class of shares. If preferential dividends are offered and paid to the low-vote shares, insiders receive a disproportionately lower amount of the proceeds. In contrast, a zero dividend policy allows insiders to share at least equally in increases in firm value.

4.1 Statistical analysis

The dividend variables used in this section represent the impact of actual dividends as well as dividend promises. We examine actual dividend payments because both forms of preferential dividend promises allow managers to avoid paying higher dividends to the low-vote shareholders by not paying any dividends or by paying equal dividends when at least equal dividends are promised. Actual dividend payments may help to resolve uncertainty and reflect the true dividend intentions of management.

Table 3 shows that in 55% of the annual observations when firms in our sample promised

a preferred dividend, they actually did pay a higher dividend to the low-vote shares. When at least an equal dividend was promised, a higher dividend was actually paid in 30% of the cases. Overall, the incremental dividend yield averaged only about one half of one percent.

Table 3
Actual Dividend Policy by Firms that Promise the Possibility
of Preferential Dividends from 1984–1999

	# of Firms	# of Annual Observations	Actually Pay Preferential Dividends	Preferential Dividend Yield
Firms that Promise at Least an Equal Dividend	23	243	73 (30%)	.55%
Firms that Promise a Preferred Dividend	31	240	132 (55%)	.46%

Actual preferential dividends cannot be directly added as explanatory variables to our previous regression, without causing statistical problems, because this would also capture the form of the dividend promise since only firms that promise preferential dividends can pay them. Instead, we construct interactive variables that reflect both the relative size of the preferential dividend and the related dividend promise. *DIVIDEND YIELD (ATLEAST)* and *DIVIDEND YIELD (PREFERRED)* are calculated by first taking the difference of the low-vote dividend minus the high-vote dividend divided by the average market price of the two stock classes. Then, the preferential dividend yield is multiplied by the dummy variable (*ATLEAST* or *PREFERRED*) that indicates the form of the firm's dividend promise. This technique allows measuring whether the payment of preferential dividends offers explanatory power beyond the promise.

We also take a less sophisticated approach by omitting the dummy variables, *ATLEAST* and *PREFERRED*, and simply using a *DIVIDEND YIELD* variable calculated by taking the difference of the low-vote dividend minus the high-vote dividend divided by the average market price. Finally, we try a *DIVIDEND DUMMY* variable that equals one if preferential dividends are paid and

zero otherwise. These variables simultaneously reflect the promise and the payment of preferential dividends.

The regression results in Table 4 show that the variables reflecting actual preferential dividend payments beyond the promise of preferential dividends are not significant. However, the variables representing the promises remain significant. When the variables representing the promises are omitted, *DIVIDEND DUMMY* is significantly negative but *DIVIDEND YIELD* is not. These results indicate that it is the promise of preferential dividends rather than their actual payment that lowers the premium on the high-vote shares.

Table 4
OLS Regression Results Adding Actual Dividend Behavior
to Explain the Annual Price Ratios of the High-Vote Stock Divided
by the Low-Vote Stock for 98 firms from 1984-1999

Independent Variable	Coefficient (<i>t</i> -value)	Coefficient (<i>t</i> -value)	Coefficient (<i>t</i> -value)
Intercept	1.059 (22.52)**	0.972 (22.69)**	0.986 (22.87)**
<i>ATLEAST</i>	-0.030 (-2.18)**		
<i>PREFERRED</i>	-0.079 (-5.57)**		

<i>PLAY</i>	0.233 (13.46)**	0.229 (13.03)**	0.229 (13.03)**
<i>VOTE%</i>	0.062 (1.22)	0.133 (2.75)**	0.121 (2.51)**
<i>INSIDER%</i>	-0.029 (-2.60)**	-0.034 (-3.00)**	-0.033 (-2.86)
<i>LIQUIDITY</i>	-1.303E-08 (-1.35)	-1.209E-08 (-1.24)	-1.244E-08 (-1.27)
<i>PERFORMANCE (ROA)</i>	-0.003 (4.90)**	-0.003 (4.51)**	-0.003 (4.39)**
<i>DIVIDEND YIELD (ATLEAST)</i>	-0.321 (-0.53)		
<i>DIVIDEND YIELD (PREFERRED)</i>	0.674 (0.60)		
<i>DIVIDEND YIELD</i>		-0.499 (-0.92)	
<i>DIVIDEND DUMMY</i>			-0.027 (-2.09)**
Adjusted R ²	.232	.206	.209
F Value	29.33**	37.33**	38.07**
Observations	839	839	839

** Significant at the .05 level.

This table reports the results of the equation used in Table2 with the following additional variables considered:

$$DIVIDEND\ YIELD\ (ATLEAST) = \{ATLEAST \times (low\text{-}vote\ dividend - high\text{-}vote\ dividend)\} / \{(high\text{-}vote\ price + low\text{-}vote\ price) / 2\}$$

$$DIVIDEND\ YIELD\ (PREFERRED) = \{PREFERRED \times (low\text{-}vote\ dividend - high\text{-}vote\ dividend)\} / \{(high\text{-}vote\ price + low\text{-}vote\ price) / 2\}$$

$$DIVIDEND\ YIELD = (low\text{-}vote\ dividend - high\text{-}vote\ dividend) / \{(high\text{-}vote\ price + low\text{-}vote\ price) / 2\}$$

$$DIVIDEND\ DUMMY = 1.0\ \text{if}\ preferential\ dividends\ are\ paid\ \text{and}\ 0\ \text{if}\ equal\ or\ no\ dividends\ are\ paid$$

4.2 Discussion

Insiders promise preferential dividends to low-vote shares because they must expect to benefit from the promise. Specifically, insiders benefit from a dual-class recapitalization through greater voting power with constant or decreased equity investment. The promise of preferential dividends encourages approval of the recapitalization and promotes subsequent conversion of high-vote shares to low-vote shares. In addition, insiders may promise preferential dividends

because they anticipate issuing low-vote equity following the recapitalization and have incentive to support the market price of the stock.

The pricing of preferential dividend promises depends on non-insiders believing that it is in the best interests of insiders to follow through with their promise. Paying preferential dividends to the low-vote shares will facilitate subsequent issues of low-vote equity providing a positive signal that increases firm value. Also, many firms recapitalize to two classes of common stock because the personal wealth constraints and/or diversification concerns of insiders often prevent them from maintaining or increasing their ownership share. The payment of cash dividends is an effective strategy for withdrawing value from the firm without reducing voting power. Thus, when non-insiders perceive that insiders have the incentive to pay dividends, then the promise of preferential dividends to low-vote shares is more credible.

Our regression results from Table 4 show that it is the promise of preferential dividends rather than their actual payment that lowers the voting premium. Dual-class recapitalizations may be viewed as transactions that harm non-insiders by insulating management. Alternatively, dual-class recapitalizations may allow firms to access positive net present value projects by issuing additional capital without insiders losing voting control. Firms that recapitalize to increase firm value have the incentive to signal that motivation. A preferential dividend promise is more credible when future profits are expected, and may serve as an effective signal of insiders' positive intentions. Thus, our results indicate that the signal of the promise may dominate any resolution of uncertainty when preferential dividends are actually paid.

5. Summary

This paper examines the relative pricing of the high and low-vote shares of 98 firms with two classes of common stock trading in the U.S. during the period from 1984 to 1999. Ratios of the market prices of high to low-vote stock are used to measure the value of the vote. The observed voting premiums are higher than those reported in previous studies of U.S. firms and are highly dependent on the form of dividend promise to the low-vote shareholders.

The relationship between the observed premiums on high-vote shares and firm specific variables is investigated to determine the source of the value of corporate control. Preferential dividend promises to low-vote shareholders reduce the voting premium, providing evidence that voting power can be priced and purchased with higher dividends. Results indicate that it is the signaling effect from the promise of preferential dividends, rather than their actual payment, that lowers the premium on the high-vote shares. The presence of a control threat significantly increases the voting premium indicating that the option to participate in a takeover premium may induce non-insiders to pay a higher price for high-vote shares. The voting premium also increases with poor firm performance and when insiders do not hold controlling voting power. This indicates that the option to exercise control to discipline managers to improve performance is most valuable when a firm is under performing and when voting rights have potential marginal impact. Voting rights have value if they provide shareholders the opportunity to exert pressure that improves performance and increases the value of future cash flows, even in the absence of a direct threat of a takeover.

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