Using a Live Case to Teach Dual-Class Stocks and Corporate Governance

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ABSTRACT

In this article we introduce a case discussion project that utilizes a "real-life story" to teach important corporate finance subjects such as shareholder rights and dual-class stocks. We start with a background review of the shareholder rights and dual-class shares topics, and then introduce our teaching approach with a combination of a short live case and lecture, including a list of discussion questions that can be used to guide students in their process of applying textbook concepts to analyze real business issues.

INTRODUCTION

Case teaching has long been supported by finance faculty. It enables students to link theories, conceptual models, and analytical techniques to the actual practice of finance. The benefits of the case method have been described by works such as Roulac (1975), Trahan (1993) and Banning (2003). In this paper we present a "live case" approach to introduce the theory and concept of shareholder rights and corporate governance to finance students. This case can be used in both introductory and intermediate level corporate finance courses. We will start with a review of the topic-- shareholder rights and dual-class shares, and then continue with an introduction of our approach of teaching these topics with a combination of a short live case and lecture. The review content can also be used by instructors at their discretion in their lectures as background introduction for the covered topics.

BACKGROUND REVIEW

1. Shareholders' Voting Rights

As Gomper, Isshi and Metrics stated in their seminal paper [Gomper, Isshi and Metrics (2003)] on corporate governance, "Corporations are republics. The ultimate authority rests with voters (shareholders)." Shareholders' rights and corporate governance are essential topics in introductory and intermediate level corporate finance courses. Every finance student should understand that common stock holders, being investors and owners of a public company, have different rights or responsibilities compared to debt holders and preferred stock holders. Among these rights, the right of voting may be considered as the most important. Classic agency theory in financial economics tells us that in corporations, ownership and control are separated. The options through which shareholders can maximize their welfare are in the broad set of corporate governance principles enumerated in the corporation's articles of incorporation and bylaws. The most important legal right shareholders have is the right to vote on important corporate matters, such as elections of boards of directors, mergers and liquidations [Easterbrook and Fischel (1983)] and such other issues as the board elects to submit for shareholder consideration.

However, shareholders have not been able to use this right much until recently. As summarized by Gillan and Starks (2007), shareholders' options have been limited—it would be much easier to "vote by feet" and liquidate their shares if they disagree with the company's decisions or get pessimistic about the company's future. It was not until 1942 when SEC introduced a rule (the predecessor of today's Rule 14a-8) that shareholders were allowed to submit proposals for inclusion on corporate ballots. Since then various groups of shareholders, including both individual and institutional shareholders, have become more and more active in participating in the governance of their corporate holdings and using their voting rights to push for changes in public companies. These active investors are sometimes called "gadfly" investors since they frequently voice their dissatisfaction and submit shareholder proposals, which may or may not sound pleasant to the corporate executives or even the board members. These investors include, but are not limited to, hedge funds, public pension funds and private equity funds, as well as individuals (retail investors).

2. Dual-class Stocks

Finance students may be surprised to learn that, not all common stock holders have "equal" rights. When founders or early investors want the public equity market to provide financing but do not want to give up their control on the company, they adopt the multiple-class stock structure. This structure allows them to get most of the voting power while only owning a small portion of a company's total stock. In most cases, these super-voting shares are not publicly traded and company founders and their families are most commonly the controlling groups in dual-class companies. Brigham and Daves briefly describes this in their widely-adapted corporate finance textbook: "the use of classified stock enabled the public to take a position in a conservatively financed growth company without sacrificing income, while the founder retained absolute control during the crucial early stages of the firm's development", and "the right to vote is often a distinguishing characteristic between different classes of stock" (Brigham and Daves, Intermediate Financial Management, 11e, Page 166-167).

Dual-class share structures used to be rare and primarily in family-run businesses or media companies. Today several hundred companies in the United States, including high-profile companies such as Google, Facebook, and Zynga, have adopted the dual-class structure in their stock ownership design. For example, Google adopted the dual-class structure for its IPO in 2004, and the arrangement has become popular among technology companies. In addition, Google's recent stock split in April 2014 took things to a new level, selling Class-C shares with no voting rights at all. In Facebook, Mark Zuckerberg controls the Class-B shares, which give him ten times the voting power of the A-shares sold to outside shareholders. This way the 18% ownership he owns of the company gives him controls over more than 50% of the voting power. The dual- or multiple-class structure of common stocks has drawn more and more attention from both academia and investors' interests. Therefore it's important and practical to introduce this issue to our finance students.

Essentially dual-class stocks separate voting rights from cash flow rights. Whether this separation can benefit shareholders has been controversial. Researches such as Masulis, Wang and Xie (2009) report that as the divergence between insider voting rights and cash flow rights widens, CEOs receive higher compensation, managers make shareholder value-destroying acquisitions more often, and capital expenditures contribute less to shareholder value. Gompers, Isshi and Metrick (2010) also reports evidence that firm value is negatively affected by the divergence between insiders' cash flow rights and voting rights.

3. Live case approach

To help students understand the concepts and practice of shareholder voting rights and dual-class shares better, in this paper we introduce the use of a "live case". It's designed to get students involved in the learning of these important corporate governance issues. The live case is based on a real company (Ford Motor Company) and case materials used in class session can be easily collected and updated from free online sources. Teaching notes and suggestions are provided for instructors interested in using this interactive in-class case study and discussion approach.

The case material is based on Ford's 2013 Proxy Statement. In this document Ford presents a list of proposals brought by various shareholders. These proposals needed to be voted on by shareholders in their annual shareholder meeting. The document also includes the board's recommendation for decision on each proposal. The particular proposal in which we are interested focuses on issues tied to Ford's existing dual-class stock structure. And since this is a proposal made by a specific group of shareholders, this case can also serve as a case for classroom discussion on shareholders' rights.

Using short live cases in introductory or intermediate level finance courses is an effort to applying an additional technique to supplement classroom lectures. Roulac (1975) argues that lecture methods tend to be a one-way communication that merely encourage students to accumulate facts and principles and passively absorb information taught by the instructor. Addition of the case method features a "dynamic learning environment" where the students must actively participate and critically analyze a business situation. Viscione and Aragon (1978) argues that a central problem in finance education is the gap between being able to understand and apply the financial techniques required to solve end-of-chapter problems, and development of the overall analytical skills required to deal with real problems that arise in financial management. The teaching approach we propose here is consistent with the suggestion in Roulac (1975): a case is covered during the same lecture when the material is covered or during the one immediately following. This live-case approach helps to bring subject matters alive and help students to understand how shareholder rights are employed in real companies during real events.

Integrating these short live cases with lectures is practical in the introductory courses since, at this level, students have yet to learn to get familiar with case analysis and discussion, although they are comfortable with a teaching method that does not abandon lectures. Trahan (1993) advocates this integration of cases with lectures, suggesting that keeping the case very close to the lecture allows students to apply the "new" theory and see its relevancy immediately. This interactive process provides an excellent supplement to classroom lectures. Moreover, a short case as in this paper does not require too much time on the instructor's side, and it takes minimal classroom lecture time from students.

More importantly, a "live" case features current and real problems that real companies are facing. Professor Benton E. Gup in Bruner, Gup, Nunnally and Pettit (1999) discussed the value of live cases. He argues that live cases provide opportunity to apply finance theory to practical situations using the latest real-world data. This hands-on approach keeps things real and interesting as new developments emerge day-to-day. Moreover, live cases help students to learn to use their judgment in dealing with issues, rather than seeking a single “right answer” as when they are working on the end-of-chapter questions.

It’s also worth mentioning that although in this article we mainly discuss the use of this live case approach in the context of classroom lectures, this approach and its contents can also be easy integrated into an online discussion platform. Krentler and Willis-Flurry (2005) shows that use of technology such as online discussion board does enhance student learning. Therefore our approach can contribute to both traditional and online course designs and improve student learning in various ways.

TEACHING NOTES

A public company like Ford Motor Company needs to file a proxy statement, otherwise known as a Form DEF 14A (Definitive Proxy Statement), with the SEC, and send to its shareholders before its scheduled annual shareholder meeting. The proxy statement contains important information such as voting procedure, proposals that await shareholders’ vote, background information about the company's nominated directors, and board member and executive compensation along with voting recommendations regarding adoption or rejection of proposals to be considered during the annual meeting.

In this article we will use Ford’s 2013 proxy statement for illustration, but instructors can use the latest version available at the time the class is taught. This document can be downloaded for free from the SEC website[1]. The full title of this document is “Notice of 2013 Annual Meeting of Shareholders and Proxy Statement”. A PDF version of this document can also be downloaded directly from Ford’s website, under the web page of Investor Relations[2].

While the original document is more than 170-page long, the instructor can provide student several pages out of this important document instead of the entire document. Alternatively, students can be assigned to access and download the document, then print the required pages for use in class. This will provide students with practical access to this website for future reference.

We are particularly interested in the following three parts:

- Page 2-8 (Questions and Answers About the Proxy Materials and the Annual Meeting);
- Page 93-94 (Shareholder Proposals: Proposal 7)

The contents selected can be related directly to topics taught in a variety of Finance courses. This case study takes approximately 30 minutes, and can easily be adapted into any class session. The classroom discussion can be organized with two segments. The first segment focuses on the background issues such as the nature of a proxy statement, shareholders’ rights, and how would shareholders voice their opinions during annual shareholder meetings. The second segment focuses on the dual class shares, including the opinion toward the dual-class structure from different parties.

Focus 1: Shareholders’ Rights

The instructor can start by leading students to read Ford's description of the purpose of the proxy statement. In this document, the company provides explanation for questions such as "what is a proxy", "what is a proxy statement", and "what is the purpose of the annual meeting". Overall, reading through these pages can help students gain understandings about the basic concepts on corporate governance and shareholder rights in the context of Ford company.

Discussion Questions:

1. What is a proxy statement? Why do companies prepare proxy statements?
2. What kind of information is usually included in the proxy statements?
3. What is the procedure of shareholder proposals and voting process? If you are a Ford shareholder, what do you need to know about your voting rights and how to use your voting rights?

These questions reinforce students' understanding about some basic concepts such as shareholders' rights and corporate governance. They can also give students a practical guideline about the execution and limitation of shareholders' voting rights in a big public company.

Focus 2: the Dual-Class Structure in Ford

The second area of discussions focuses on the dual-class structure in Ford. According to the proxy statement, as of March 2013, Ford has 3,858,409,150 shares of common stock and 70,852,076 shares of Class B Stock outstanding (see Page 2 of the Proxy Statement). As explained in the proxy statement, in terms of dividend rights, shares of Common Stock and Class B Stock share equally in dividends when and as paid, However, in terms of voting rights, holders of common stock have 60% of the general voting power, while holders of Class B Stock have the remaining 40% of the general voting power (Page 3). Therefore each outstanding share of Class B Stock will be entitled about to 36 votes on each matter to be voted upon[3].

The controversy from the dual-class shares can be seen in Proposal 7, which was brought up by an outsider investor, and called for shareholders' votes in the annual meeting. The board of directors also gave their opinion and recommendation following the introduction of the proposal.

Discussion Questions:

1. What are the (different) voting rights of Ford's common stock holders and Class B stock holders?
2. In Proposal 7, what are the arguments given by this shareholder for "Give Each Share an Equal Vote"?
3. What is the board's opinion in this issue? Why?
4. If you are a Ford shareholder, what would be your vote regarding this issue? Why?

These questions reinforce students' understanding about the structural design dual class stocks and the pros and cons of this design.

Voting:

After the discussions, the instructor can call for a vote among students. The voting result from the class then can be compared to the actual voting result from the shareholder's annual meeting, which can be found online under the web page of Events and Webcasts[4] in Ford's website. As a side note, according to the actual result, Proposal 7 was rejected in May 2013's annual meeting (out of the 4,508,110,660 votes casted, 33.4% of the shareholders voted for the proposal, while 66.6% voted against it).

Another interesting remark the instructor can make to the class is that, as a matter of fact, the same proposal can be found from Ford's proxy statement from previous years, initiated by the same investor/shareholder. It seems that they've kept fighting the same cause over years, yet still haven't managed to get the majority votes. We would not be surprised to see the same proposal awaiting shareholder's voting in next year's annual meeting.

SUMMARY

Using a real-company case material can enhance students' understanding about important corporate finance subjects such as corporate governance and shareholders' right. It motivates students to go beyond theories and concepts introduced in textbooks and try to understand what's going to in today's corporate world. In this paper we introduced a simple short live case that can be smoothly integrated with classroom lectures. This teaching technique allows classroom discussions to stay close to both lecture subjects and current corporate practices in the real world.

ENDNOTES

[1] link: http://www.sec.gov/Archives/edgar/data/37996/000104746913003543/0001047469-13-003543-index.htm

[2] Link: http://corporate.ford.com/our-company/investors/reports-financial-information/proxy-statements?releaseId=1244755069042

[3] This ratio is estimated by $\frac{3{,}858{,}409{,}150 * 40\%}{70{,}852{,}076 * 60\%}$

[4] Link: http://corporate.ford.com/our-company/investors/upcoming-investor-events/webcastevent-detail/fmcwebcast-20130509?packedargs=releaseId%3D1244757804990

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