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Kose John
Anil K. Makhija
Editors

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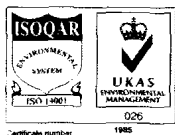
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LIST OF CONTRIBUTORS

<i>Effiezal Aswadi Abdul Wahab</i>	Universiti Sains Malaysia, Pulau Pinang, Malaysia
<i>Ronen Barak</i>	Bar-Ilan University, Ramat Gan, Israel
<i>Josep Garcia Blandón</i>	Facultat d'Economia, IQS, Universitat Ramon Llull, Barcelona, Spain
<i>Mónica Martínez Blasco</i>	Facultat d'Economia, IQS, Universitat Ramon Llull, Barcelona, Spain
<i>Josep Maria Argilés Bosch</i>	Universitat de Barcelona, Barcelona, Spain
<i>Shmuel Cohen</i>	Bar-Ilan University, Ramat Gan, Israel
<i>Ari Ginsberg</i>	NYU Stern School of Business, New York, NY, USA
<i>Hasnah Haron</i>	Universiti Sains Malaysia, Pulau Pinang, Malaysia
<i>Iftekhar Hasan</i>	Rensselaer Polytechnic Institute and Bank of Finland, Troy, NY, USA
<i>John S. Howe</i>	University of Missouri-Columbia, Columbia, MO, USA
<i>Haslindar Ibrahim</i>	Universiti Sains Malaysia, Pulau Pinang, Malaysia
<i>Beni Lauterbach</i>	Bar-Ilan University, Ramat Gan, Israel
<i>Char Lee Lok</i>	Universiti Sains Malaysia, Pulau Pinang, Malaysia
<i>Etienne Redor</i>	Audencia Nantes Ecole de Management, Nantes France

<i>Peter Roosenboom</i>	Erasmus University, Rotterdam, the Netherlands
<i>Fazilah M. Abdul Samad</i>	Universiti Malaya, Kuala Lumpur, Malaysia
<i>Willem Schramade</i>	Erasmus University, Rotterdam, the Netherlands
<i>Chris Tamm</i>	University of Missouri-Columbia, Columbia, MO, USA
<i>Christopher L. Tucci</i>	Ecole Polytechnique Fédérale de Lausanne (EPFL), Lausanne, Switzerland
<i>Sofri Yahya</i>	Universiti Sains Malaysia, Pulau Pinang, Malaysia

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CORPORATE GOVERNANCE OF DUAL-CLASS FIRMS

John S. Howe and Chris Tamm

ABSTRACT

We compare the governance characteristics of dual-class firms to a matched sample of single-class firms. Dual-class firms allow firms to separate voting and cash flow rights, frequently allowing management to control the voting rights while only having a small proportion of the cash flow rights. With the control of the voting rights, management has the ability to choose governance characteristics to further entrench itself or help protect the rights of the minority investors. We show that dual-class firms are less likely to have independent boards and have lower levels of institutional ownership. However, dual-class firms are more likely to have separate individuals as CEO and Chairman of the Board and less likely to have staggered boards, which are considered to be good governance characteristics.

1. INTRODUCTION

In the past twenty-five years, there has been a significant amount of academic literature examining dual-class companies in the United States. These types of firms have more than one class of common stock and comprise about 6% of the publicly traded companies in the United States.

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In many cases, the firms have a publicly traded class and one non-publicly traded class. The publicly traded classes typically have one vote per share, while the non-traded class has multiple votes per share. The non-traded class is frequently owned by the management of the firm and allows them to virtually control all voting issues.¹

Much of the prior dual-class literature has focused on firm value and performance, in particular comparing the values of dual-class firms with single class firms. We extend the dual-class literature by focusing on other governance characteristics, specifically comparing governance characteristics of dual-class firms with those of a matched sample of single-class firms. Overall, the dual-class structure is generally considered to be a weak governance characteristic, and prior literature has shown there is the potential for significant problems when using this structure. Lease, McConnell, and Mikkelson (1984) was one of the first papers to show this likelihood of potential problems leads to inferior shares of dual-class firms trading at a discount to single-class firms. We examine other governance characteristics to determine if dual-class managers must take other steps to attempt to mitigate the inherent problems of the dual-class structure in order to help protect minority investors.

In dual-class firms where management controls the majority of the voting shares, managers have an opportunity to use their voting power to further entrench themselves or to potentially help mitigate the inherent problems of the dual-class structure. For example, the CEO can potentially ensure that he is also the Chairman of the Board of Directors or he may elect friends or insiders to the board of directors. These actions help further entrench the management of the firm. In contrast, management can use its ability to control voting issues to separate the Chairman and CEO and elect more outside directors to the board. By taking these actions, management is helping outside investors better monitor management's actions and protecting the rights of minority shareholders.

The governance characteristics may be a function of management's desires because management controls the majority of the votes. However, there may be situations where management cannot use its voting powers to further entrench themselves. For example, if management wants to raise external debt or equity, the financiers may only be willing to provide funds if they have some ways to better monitor and potentially limit the actions of management. One method to accomplish this may be to require better governance characteristics.

The specific governance characteristics we examine are the firm's board size, the percentage of inside and outside directors, whether the CEO and

Chairman of the Board are separate individuals, the presence of a staggered board of directors, cumulative voting, and institutional ownership levels. These characteristics can all allow management to further entrench themselves or offer substantial protections to minority investors depending on the structure used.

The remainder of the paper is organized as follows. Section 2 discusses related literature. Section 3 describes the data. Section 4 provides the results and Section 5 concludes.

2. LITERATURE REVIEW

2.1. Dual Class Common Stock

A significant amount of prior research has been conducted on firms with more than one class of common stock. DeAngelo and DeAngelo (1985) started this literature when they examined differences in managerial ownership and voting rights in dual-class firms. They found that managers hold a majority of the voting rights with only about 25 percent of the ownership rights in a small sample of dual-class firms. This difference between ownership and voting rights is generally viewed as a negative characteristic, which leads to poor firm performance and lower firm values. Having separate ownership and voting rights allows the owners of the super voting shares to potentially extract private benefits of control as described in Jensen and Meckling (1976). These costs lead investors to pay less for the inferior shares because of the fear of expropriation or the expectation that weaker shareholder rights leads to poor performance.

Since DeAngelo and DeAngelo (1985), literature has primarily focused on three areas related to dual-class stocks. The first is the relationship between firm value and ownership structure. The second is the relative value between shares with different voting rights, while the third area examines the effects of dual-class recapitalizations.

Much of the prior literature examining the relationship between firm value and ownership structure has been focused on international firms because of the high prevalence of dual-class firms in other countries. In particular, Lins (2003) and Claessens, Djankov, Fan, and Lang (2002) examine the relationships between firm value, voting rights, and cash-flow rights in eighteen emerging markets and eight East Asian countries respectively. Their results indicate that firm value decreases when voting rights exceed cash-flow rights. One potential explanation for these findings is

that the managers are using their substantial voting rights to expropriate wealth from minority shareholders.

More recently, Gompers, Ishii, and Metrick (2010) conduct a detailed analysis of dual-class firms in the United States. They show that these firms comprise about 6% of all outstanding firms; however, they are more prevalent in certain industries. They show that many of these firms are present in media and telecommunications industries. This finding is consistent with the private benefits of control because newspaper and television firms may offer many private benefits as described in Demsetz and Lehn (1985). In addition, they show that if a person's name appears in the company's name, the firm is likely to have a dual-class structure. Overall, they find firm value is affected by cash flow, voting rights, and the difference between the two. As insider cash flow rights increase, firm value also increases. In contrast, as insider voting rights increase, firm value decreases. Finally, they show that as the difference between cash flow and voting rights increases, firm value decreases.

One concern about the link between firm value and ownership structure is presented in Demsetz and Lehn (1985). They argue that the ownership structure is an endogenous variable and that firms can have different types of optimal ownership structures. This means that a dual-class structure could be optimal in certain situations and is not an inherently poor governance characteristic as it is commonly assumed.

Prior literature has shown that there is a significant difference between the values of shares with superior voting rights when compared to the values of shares in the inferior class. Nenova (2003) examines the relative value between superior and inferior classes of stock in 18 countries. He divides the countries according to legal origins following La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) and finds that there is only about a 2% difference in value between the two classes of stock in the United States. This difference is slightly lower than the 3% to 8% found in other studies such as Zingales (1995) and Cox and Roden (2002). Such a small difference may indicate that managers in dual-class firms are not using the structure to entrench themselves. However, it also indicates that the managers must take other steps in order to protect investors in the inferior class.

Because there are very few cases of dual-class firms becoming single-class firms after IPO, prior literature has examined the shareholder wealth effects on firms undertaking dual-class recapitalizations. Dual-class recapitalizations occur when management issues a second class of stock, often with inferior voting rights to the current class outstanding. Lehn, Netter, and Poulsen (1990) examine the reasons that firms might undertake a dual-class

recapitalization. They find firms with greater growth opportunities are more likely to use a dual-class recapitalization to maintain control of the firm while still raising external equity.

2.2. Corporate Governance

There has been a significant debate about whether or not corporate governance affects firm performance and value. Gompers, Ishii, and Metrick (2003) develop a “Governance Index” (“G”) as a proxy for shareholder rights. Their results indicate that the firms with stronger shareholder rights had higher values as measured by Tobin’s Q, higher profits, higher sales growth, and made fewer corporate acquisitions. One of the characteristics considered in the G index is the presence of a dual-class structure, which is treated as a weak characteristic and is associated with poor performance. They show that firms with stronger shareholder rights have risk-adjusted annual stock returns that are over 8% higher than firms with weak shareholder rights between 1990 and 1999. While they show significant stock market underperformance, they do not find a significant difference in operating performance as measured by return on equity. They propose two potential explanations of these findings. The first is that poor governance characteristics increases the agency costs, which are not accounted for by investors. The second explanation is that this finding is only because of the time period examined and that governance is a proxy for some other characteristic affecting stock returns.

Core, Guay, and Rusticus (2006) examine the two potential explanations and find no support for the explanation that weak corporate governance leads to poor stock performance. Instead, they argue that the findings may be time-period specific and are instead a result of differences in expected returns. Gompers et al. (2010) indicate one of the most powerful corporate governance characteristics is the presence of multiple classes of common stock. They find that the larger the voting rights of insiders in dual-class firms, the lower the value of the firm. We examine whether firms with this structure use other governance characteristics to help protect outside investors or instead use the dominant structure to further entrench themselves. Specifically, we examine the firm’s board size, the percentage of inside and outside directors, whether the CEO and Chairman of the Board are separated, the presence of a staggered board of directors, cumulative voting, and institutional ownership levels.

The first governance characteristic we examine is the size of the board of directors. Lipton and Lorsch (1992) argue “most boardrooms are dysfunction” and recommend boards contain only eight or nine members because larger boards are more inefficient. They suggest that large boards have costs including slower decision-making processes, biases against risk-taking, and poor CEO compensation incentives. In contrast, smaller boards allow members to have more effective discussions and come to a true consensus. Yermack (1996) shows that firms with small boards have a higher value, as measured by Tobin’s Q, than firms with larger boards. He also finds that firms with small boards have better operating performances and provide stronger CEO incentives. These papers indicate that while a larger board may provide advantages when overseeing the firm, the problems in the decision making process outweigh the potential benefits.

We next examine the number of inside and outside directors on the board. There has been a substantial amount of literature arguing that firms should have a majority of outsiders on its board. Fama and Jensen (1983) argue that boards should be “composed of experts,” many of whom should be outsiders, who bring expertise and potentially important connections to the firm. Hermalin and Weisbach (1988) indicate that board independence limits the ability of the CEO to control the board, and they find that firms tend to add outside directors following times of poor performance. More recently, with the passage of the Sarbanes-Oxley Act and the listing rules of the New York Stock Exchange and NASDAQ, firms have to have a majority of independent directors and audit, compensation, and nominating committees have to be entirely independent.

In contrast, Harris and Raviv (2008) develop a model showing that for many firms, shareholders should prefer an insider controlled board. This result is particularly true for firms where insiders have a significant amount of information that is not readily available to outside directors. However, in their conclusion, Harris and Raviv state “On the other hand, if agency costs are large, our model generally predicts that outsider-control is optimal. In that case, regulations mandating such control are consistent with optimality.” Based on the structure and conflicts of dual-class firms discussed earlier, they show additional support for independent boards.

The next governance characteristic we examine is whether the CEO and Chairman of the Board positions are separated. Over the past twenty years, there has been a significant debate about this issue. Jensen (1993) argues that the CEO and Chairman positions must be separate because the “function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO.” Brickley, Coles, and Jarrell (1997)

argue that separating the positions may cause substantial problems and result in additional monitoring costs, which offset the potential advantages of separate positions. They find the firms with separate positions do not perform better than firms with the same person serving in both roles. Goyal and Park (2002) show that firms where the CEO also serves as the Chairman are less likely to change CEOs after periods of poor performance. It may be especially important for dual-class firms to have a separate CEO and Chairman to help limit the power of management.

One way managers attempt to entrench board members is through the staggered board structure. Firms can have a unitary board where all directors stand for election each year or a staggered board where directors are grouped into classes with one class standing for election each year. Most staggered boards have three classes, meaning once elected the directors serve for a period of three years instead of the usual one year unitary board members serve for. This structure ensures that it takes at least two years for shareholders to elect a majority of the board, limiting the ability of shareholders to make changes quickly.

Bebchuk, Coates, and Subramanian (2002) find staggered boards are one of the most effective antitakeover defenses a firm can have. They argue that the structure is so effective because it requires hostile bidders to wait at least fourteen months to control the board and to win two elections a year apart. Their results also show that target shareholders have their expected return reduced by 8-10% in the nine months after a hostile bid is launched. Bebchuk and Cohen (2005) find firms with staggered boards have lower value than those with unitary boards; however, their analysis explicitly excluded dual-class firms. This decreased value may be a result of the inability of hostile bidders to acquire the firm.

We next examine how stockholders elect members to the board of directors. Straight voting means each shareholder has a number of votes equal to the number of shares held, which are then used to vote on each seat separately. In contrast, cumulative voting allows owners to cast all of their votes in favor of one person or distribute them among multiple candidates. Each share provides the owner with as many votes as there are directors being elected. The ability to pool votes allows minority shareholders to elect board members even when the majority of shareholders oppose their election.

The presence of cumulative voting is detailed in the firm's charter; however, state law often dictates the default options for most firms. Some states require cumulative voting unless the firm specifically prohibits it, while the majority simply allows the firm to choose. In addition, most firms

can change from one form to the other through charter amendments, which have become increasingly popular recently. Six states (Arizona, California, Nebraska, North Dakota, South Dakota, and West Virginia) require publicly traded firms to have cumulative voting. In addition, federal laws require national banks to have cumulative voting.

Bhagat and Brickley (1984) show changes to a firm's charter affecting cumulative voting rights can have a significant impact on firm value. They find that when firms announce charter amendments to eliminate cumulative voting, their shares experience an average two-day return of -1.57% compared to a market return of 0.06% in the same time period. Gompers et al. (2003) states cumulative voting is "usually proposed by shareholders and opposed by management." The presence of cumulative voting may be especially important in dual-class firms as it may offer additional protections to minority shareholders by ensuring they have the ability to elect some board members.

Finally, we examine the institutional ownership levels for each firm. Shleifer and Vishny (1986) show that atomistic investors do not have the ability or incentive to adequately monitor management. They show that institutional investors are often large shareholders who are able to monitor management's actions. The presence of institutional owners may be especially valuable in dual-class firms because management has the opportunity to use their substantial voting power to expropriate wealth from minority investors. Smart and Zutter (2003) compare the performance of dual-class and single-class firms after initial public offerings (IPO) and find that dual-class firms have a significantly higher post-IPO institutional ownership level, indicating institutions are taking large positions in dual-class firms.

Table 1 provides a summary of the governance characteristics we examine. We provide projections about what constitutes a balanced governance characteristic and what constitutes an entrenched characteristic. The balanced characteristics help protect the interests of minority shareholders, while entrenched characteristics can be used by management to limit the influence of minority investors.

3. DATA

The list of dual-class firms is from Andrew Metrick and described in detail in Gompers et al. (2010). This dataset includes all dual-class firms where at least one class of common stock is publicly traded between 1995 and 2002.

Table 1. Characteristics of Balanced and Entrenched Boards.

Category	Balanced	Entrenched
Number of directors	Smaller	Larger
Independent board	Yes	No
CEO/chairman split	Yes	No
Staggered board	No	Yes
Cumulative voting	Yes	No
Institutional ownership	Higher	Lower

Notes: This table indicates the characteristics of balanced and entrenched board of directors. Independent board is a measure of whether at least 50% of the board members are not corporate officers. CEO/chairman split measures whether the CEO and chairman of the board are different individuals. Staggered board measures whether the firm elects a class of directors each year or if the firm elects all directors at a time. Cumulative voting examines whether the firm uses cumulative voting or straight voting. Institutional ownership is the percent of shares owned by institutional investors.

Their sample is much larger than many of the prior studies because it considers all dual-class firms, not just specific subsets such as where all classes are publicly traded or “family controlled” firms.

We create a matched sample of single-class firms based on SIC code and firm size. First, we obtain all of the single-class firms in the same three digit SIC code as the dual-class firm and then select the single-class firm with the closest total assets. If the single-class firm’s total assets are within 25% of the original dual-class firm, we use that as a match. In situations where there is not a single-class firm to match to with 25% of total assets, we repeat the process using only two digit SIC codes. This matching process resulted in us matching 668 of the original 744 dual class firms, for a 90% match rate.

We collect information about governance characteristics from several sources. Information about the number of directors and officers, board independence, and CEO/Chairman of the Board duality was collected from Compact Disclosure when available and from the firm’s annual reports otherwise. To determine if the firm had a staggered board of directors and/or used cumulative voting, we examined the annual reports and 10Ks. We obtain institutional ownership information from Thomson Financial.

Table 2 details the number of dual-class firms by SIC code. The largest category is Manufacturing, with over one third of the firms in this division. The next two largest Transportation, Communications, Electric, Gas and Services have almost one third of the firms when combined. In contrast, Agricultural Production Crops, Mining, Construction, and Wholesale

Table 2. Number of Dual-Class Firms by SIC Division.

SIC Division	Number of Firms	Percent of Firms	Classes of Stock		
			2	3	4
A: Agricultural production crops	3	0.4	3	0	0
B: Mining	8	1.2	8	0	0
C: Construction	15	2.2	15	0	0
D: Manufacturing	248	37.1	236	12	0
E: Transportation, communications, electric, gas	115	17.2	97	14	4
F: Wholesale trade	32	4.8	32	0	0
G: Retail trade	63	9.4	60	3	0
H: Finance, insurance, and real estate	73	10.9	68	3	2
I: Services	111	16.6	104	6	1
Total	668	100	623	38	7

Notes: This table summarizes the number and percent of dual-class firms in each of the nine SIC divisions. The classes of stock indicate the number of firms with 2, 3, and 4 classes of common stock in each SIC division.

Trade each have less than five percent of the total firms. Table 2 also details the number of classes of stock the firms have in each industry. Over 93% of the firms have two classes of common stock, while 6% percent have three classes. The remaining one percent has four classes. The firms with more than two classes of common stock are concentrated in the Manufacturing and Transportation, Communications, Electric, Gas divisions.

Table 3 details the voting and cash flow structures of the dual-class firms. Panel A shows the voting structure of dual-class firms is very different across firms. There is not one dominant structure found in the vast majority of firms. The most common structure, found in almost 30% of the firms, is for the superior class to have 10 votes per share while the inferior class only has 1 vote. The next most common structure is for firms to have one class of stock that votes for the entire board of directors while the second class does not have any voting rights. Over 20% of the firms have a proportional voting structure, where each class gets to elect a specific proportion of the members of the board of directors. The least common structure, present in less than five percent of firms, is where the inferior voting shares have a voting ratio less than 1 to 10.

Panel B shows the cash flow structure of the dual-class firms. In contrast to the voting structure, the vast majority of dual-class firms have cash flow

Table 3. Voting and Dividend Structure.

	Number of Firms	Percent of Firms
<i>Panel A: Dual-class voting structures</i>		
Voting ratio < 1:10	32	4.8
Voting ratio = 1:10	200	29.9
Voting ratio > 1:10	119	17.8
Proportional directors	153	22.9
Nonvoting class	164	24.6
<i>Panel B: Dual-class cash flow structures</i>		
Superior > inferior	16	2.4
Superior = inferior	576	86.2
Superior < inferior	76	11.4

Notes: This table details the voting and dividend structures of dual-class firms. Panel A details the voting class structure between the superior and the inferior classes. Proportional directors indicates each class of stock has the ability to elect a specific number of directors. Nonvoting class indicates at least once class of stock does not have any voting rights. Panel B details the cash flow structure between the superior and inferior classes.

rights that are equal in the superior and inferior voting classes. Eleven percent of dual-class firms have inferior voting shares with greater cash flow rights than the superior voting shares. Only two percent of dual-class firms are structured so that the superior voting shares have greater cash flow rights than the inferior voting class. These findings indicate that the firms are not consistently using additional cash flow rights to compensate investors for having lower voting rights.

Table 4 details the summary statistics for the dual-class firms as well as a matched sample of single-class firms. The average dual-class firm has a total book value of assets over \$2.2 billion, while the median firm size is only about \$285 million. This statistic indicates there are several very large companies such as Berkshire Hathaway that have a very dramatic effect on the average firm size. In addition to showing no difference in total assets, we find no difference in sales, long-term debt, total fixed assets, operating income, and profit margin between the dual-class and single-class samples. There is a significant difference in net income between the two sample, with the single-class firms have a much higher average net income. Overall, this table indicates the dual-class firms are very similar to the matched sample of single-class firms in terms of financial characteristics.