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Share Class Shenanigans: Google, News Corp, Emmis, and Other Companies to Watch Out For

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Executive Summary

Recent issues related to dual share classes with disparate voting rights have sparked controversy at Google, News Corp, and perhaps most dramatically, radio broadcaster Emmis Communications. These examples demonstrate the dangers to investors that result when voting power does not align with economic interest—a risk indicator GMI Ratings has identified at over 200 publicly traded companies in the Russell 3000.

Dual Share Classes and Governance Risk

Recently, both Google and News Corp have been in the news for issues related to dual share classes with disparate voting rights. Google has announced that as part of a stock split, it will issue a new class of stock that has no voting rights for current shareholders. The plan will further solidify the power of the company's leadership, which already controls two-thirds of the voting power through special Class B shares. At News Corp, meanwhile, non-US domiciled Class B shareholders have recently seen their voting power reduced as a means of remedying the company's non-compliance with US regulations on foreign ownership of broadcasters. This step has relatively minor impact on voting at the company, since the Murdoch family already determines the outcome of any matter through its ownership of 40% of the voting stock.

At GMI Ratings, we have long collected data on companies that have dual share classes with disparate voting rights. The disjunction between economic interest and voting power that results from such arrangements, we believe, can pose a serious risk to a company's public shareholders. While this may sometimes seem like a merely theoretical concern, these recent high-profile cases are bringing more attention to the issue. It is at a much smaller firm, however, that some truly elaborate maneuverings are being facilitated by a dual-class capital structure: Emmis Communications.

The Emmis Imbroglio

It's not often that events at one company involve as many hot-button corporate governance issues as the imbroglio at radio broadcaster Emmis Communications [NASD:EMMS]. Emmis' CEO and controlling shareholder Jeffrey Smulyan, who led a failed management buyout (MBO) effort in 2010, is using complex derivative transactions and his common stock voting control—which he enjoys as a result of a dual-class share structure—to bring about a major restructuring. The situation highlights the risks of excessive management entrenchment and illustrates the need for state corporate law to catch up with evolving forms of ownership and control.

Over the past several years, companies and their advisors have repeatedly sounded the alarm over "empty voting." Accomplished through various means, including share lending and swap agreements, empty voting occurs when someone who does not own outright shares of a company's stock has the ability to control voting of those shares. Put another way, empty voting involves separating economic interest and voting rights.

Shareholders—more specifically, hedge funds—are generally viewed as the perpetrators of empty voting. A 2010 article in *Institutional Investor* described empty voting as "a practice favored by some activist hedge funds to boost their voting power without putting up much money." As a result, empty voting has been cited as a reason to be cautious about corporate governance reforms that would increase shareholder power.

But it turns out that not all companies deplore empty voting. In a surprising twist on the usual story, Emmis is planning to use empty voting techniques against its own preferred shareholders. Those with the most to lose if Emmis succeeds are hedge funds that own the company's preferred stock.

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Emmis badly wants to restructure its obligations to its preferred shareholders. Because it has not paid a preferred stock dividend since October 2008, Emmis owes those holders $21 million to which they are contractually entitled. Emmis would like for those unpaid dividends to be forgiven and for Emmis to be released from its obligation to pay dividends in the future.

Emmis is in a jam with its stock exchange regulator as well: Nasdaq has threatened to delist its common stock for non-compliance with the $1.00 minimum bid price requirement. Emmis has requested a hearing where it intends to present a plan to raise its stock price above the $1.00 minimum. Reducing its obligations to its preferred shareholders would be a useful element of such a plan. (Emmis is also seeking approval for a reverse stock split.)

What's more, any major transaction, like the MBO Smulyan tried to lead in 2010, now requires separate approval of two-thirds of preferred shares; in 2010, preferred shareholders blocked the deal. Emmis wants to eliminate preferred shareholders' right to vote separately on control transactions and to demand repurchase of their shares if a going-private transaction involving Smulyan that does not qualify as a change of control occurs. Smulyan has said he is not currently planning to propose another MBO. But removing the preferred shareholders as an impediment would benefit Smulyan should such an opportunity arise down the road.

The challenge for Emmis is that changes to the preferred stock's terms must be approved by holders of two-thirds of preferred shares. The changes Emmis wants to make have been estimated to reduce to approximately $2 the value of shares that originally sold for $50 in 1999. So Emmis figured out a way to become one of its own major preferred shareholders and consent to the changes.

In November 2011, Emmis entered into a total return swap covering over a million shares of Emmis preferred stock owned by Alden Global Capital, a fund that had agreed to finance the failed 2010 MBO and with which Emmis and Smulyan had been embroiled in litigation. A total return swap shifts the economic risk associated with owning an asset (here, the Emmis preferred stock) from the legal owner of the shares (the "payor," here Alden) to another party (the "receiver," here Emmis). Generally speaking, the payor makes periodic payments to the receiver representing the economic impact of owning the security. In the case of preferred stock, those payments would likely include dividends and changes in the value of the shares. (Emmis has not disclosed all the terms of the total return swap agreements into which it entered.)

Emmis also entered into a voting rights agreement with Alden providing that Emmis has the right to direct voting of the shares. Immediately following the transaction with Alden, Emmis had the right to direct voting of over 56.8% of its own preferred stock. (By an April 2, 2012 special meeting of shareholders, that proportion had increased to 61.3%.) Through these transactions, Emmis acquired all the rights and risks of ownership of a majority of its own preferred stock without actually becoming legal owner of the shares.

So why didn't Emmis simply buy the shares back from Alden and the other holders? The likely answer to that question is that Emmis needed to sidestep provisions of Indiana corporate law that prevent a company from voting shares that it has repurchased; if Emmis had bought back its preferred stock, Indiana law would have counted the stock as "authorized but unissued" which would mean it could not be voted.

Because Emmis, even after the total return swaps, did not control the two-thirds of shares necessary to change the preferred stock's terms, it engaged in another questionable transaction. At an April 2, 2012 shareholder meeting, common shareholders approved a proposal to issue 400,000 shares of preferred stock to a "retention plan," pursuant to which employees can receive awards of preferred stock. The earliest any grantee will actually obtain shares is April 2, 2014, however; until that time, the preferred shares in the retention plan are voted by the trustee, who is Smulyan. With the retention plan shares, Emmis (i.e.,Smulyan) controls the voting of 66.8% of preferred shares, enough to approve changes to the preferred stock up for a vote at a special meeting of shareholders, the date for which has not yet been set.

The issuance of shares into friendly hands such as an employee compensation vehicle helmed by management in order to disenfranchise existing holders is frowned upon by institutional shareholders, who typically will not vote in favor of such arrangements. Even though common shareholders won't be harmed directly by the changes to Emmis' preferred stock,

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they might oppose those changes on principle or because they fear Emmis' cost of capital might increase as a result of its conduct. They might also be leery of paving the way for an MBO in which Smulyan could benefit at the expense of other common shareholders. But those concerns don't matter: approval of the proposal creating the retention plan was a foregone conclusion since Smulyan has voting control over Emmis' common stock via a dual-class share structure in which Smulyan owns all of the supervoting shares. Those who pooh-pooh warnings about the dangers of dual-class structures should take note.

Emmis has sued several hedge funds that are working together to resist the restructuring, seeking a ruling that its strategy is legal. (The shareholders have countersued, alleging that it is not.) If that strategy is upheld, it could set a precedent allowing companies to make an end run around rules designed to prevent companies from voting their own shares and disenfranchising shareholders. Ironically, companies concerned about empty voting by shareholders will be undercut if Emmis is successful in convincing a court that form should prevail over substance.

Dual-Class Companies to Watch Out For

The following are some S&P 500 companies where dual-class structures with disparate voting rights strengthen the influence of particular investors—typically a founding family or other dominant shareholder.

- Aflac Incorporated
- Apollo Group, Inc.
- Berkshire Hathaway Inc.
- Broadcom Corporation
- Cablevision Systems Corporation
- CBS Corporation
- CME Group Inc.
- Comcast Corporation
- Constellation Brands, Inc.
- Discovery Communications, Inc.
- Estee Lauder
- Expedia, Inc.
- Federated Investors, Inc.
- Ford Motor Company
- Google Inc.
- Hershey Company (The)
- Lennar Corporation
- Molex Incorporated
- News Corporation
- Nike
- Ralph Lauren Corporation
- Scripps Networks Interactive, Inc.
- Simon Property Group, Inc.
- Tyson Foods, Inc.
- United Parcel Service, Inc.
- Visa Inc.
- Washington Post Company (The)

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